DEACONS
的近律師行

A guide to Hong Kong Security and Receivership

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Types of security

In Hong Kong, security can be created by ***agreement***, for example, a mortgage, pledge, or charge; or by ***operation of law*** such as a lien or attachment order. A security interest can be taken in respect of all forms of assets and interests whether they be tangible or not.

Details concerning specified types of security ***created*** by a company over its assets (whether legal or equitable) must be registered with the Registrar of Companies. Only companies formed and registered in Hong Kong or non-Hong Kong companies that are registered in Hong Kong are required to register the specified types of security in Hong Kong. Failure to register such security renders it void against other creditors and any appointed liquidator, whereupon the money secured by such security could, at the lender's option, become immediately payable (Section 337 Companies Ordinance (Cap. 622)).

Land and buildings

Legal charges or mortgages can be taken over fixed assets such as land and buildings. To be effective and to gain priority over other creditors, these charges require registration at the ***Land Registry*** (in addition to the Companies Registry) within the prescribed statutory timeframe.

A mortgage or legal charge over land is generally a very safe form of comfort to a creditor, but its worth depends ultimately on the value of the asset charged. This may vary considerably depending on market conditions.

An ***equitable mortgage*** (an informal but nevertheless effective arrangement) is normally created by depositing the title deeds of the property with the lender with the intention to create a mortgage. The mere handing over of the title deeds without the necessary intention is ***not*** sufficient to create any security interest, although equitable mortgages can be created without the deposit of title deeds if the necessary intention to create a mortgage is evidenced in writing.

In practice, the title deeds of land and property are normally held by the lender (commonly known as the ***mortgagee***) who has taken the "first" charge over the land.

The law does not limit the number of charges which can be granted over the same asset, in general with later ones subordinate to and ranking after earlier ones absent an express agreement otherwise.

The ***Rules of the High Court*** (Cap. 4A) enable secured creditors to realise their security by obtaining an order for possession. The mortgage deed also usually contains an express ***power of sale*** which means that an order of the court may not be necessary for the creditor to effect a sale as "mortgagee". Nonetheless, an order of the court is normally required in order to obtain vacant possession. In addition, it is common to obtain a court order when enforcing equitable charges.

Ships and aircraft

In addition to registration requirements at the Companies Registry (Sections 334(1)(g) and (h) Companies Ordinance), special rules apply to the registration of ships and aircraft and to any mortgages over these assets. It is essential that specialist legal advice is obtained in respect of any transaction concerning assets of this nature.

Other tangible assets

Other tangible assets may be given as security by either mortgage or pledge, with the latter requiring an actual or constructive transfer of possession.

Where the borrower (also known as the ***mortgagor***) remains in possession of the goods, the ***Bills of Sale Ordinance*** and the ***Companies Ordinance*** apply whether or not the security interest is evidenced in writing. These provide for complicated registration formalities which, if not complied with, render the security ineffective.

With the exception of floating charges (see "Debentures" below) and pledges with trust receipts (see "Trust receipts or letters of hypothecation" below), other tangible assets are not often taken as security, although bankers and others can sometimes obtain effective security by holding documents of title (e.g. ***Bills of Lading***).

Liens

A lien is a right to retain possession of property as security for an outstanding debt and often arises where services have been performed but remain unpaid for. A lien can arise by either express agreement or by operation of law.

Retention of title

It is becoming increasingly common for suppliers to attempt to retain (reserve) title in goods supplied by them until they have been paid for in full.

In order to be effective, any such contractual provision must form part of the agreement between the buyer and the seller. In practice, this means that the clause must not merely appear on the back of an invoice. Depending on the wording used, any attempted retention of title clause may amount to a form of security, which may be void against a liquidator if not registered.

Intangible assets

These include insurance policies, receivables (commonly known as book debts) and other rights. The Bills of Sale Ordinance does not apply to security over these assets, and as such they are normally charged by ***assignment*** with provision for re-assignment on repayment.

Security over receivables is usually created by either legal or equitable assignment. In a legal assignment, written notice of the assignment must be given to the debtors. Once notice is given, the mortgagee is able to sue defaulting debtors without the co-operation of the mortgagor. This is important because co-operation may be difficult to obtain in the event of an enforcement of security. A legal assignment can relate only to past debts. In an equitable assignment, the debtors are not given notice of the assignment and the assignee has no right to sue in his own name. This area of the law is technically difficult and a full explanation is beyond the scope of this booklet.

The ***factoring*** of commercial debts (otherwise known as "invoice discounting") is of increasing importance as a method of financing trading companies and is based on the assignment and re-assignment of receivables.

Mortgages of shares are sometimes effected by the transfer of the shares to the mortgagee with an agreement for re-transfer on repayment of the capital sum. Alternatively, the mortgagor can deposit the share certificates with the mortgagee, together with either a memorandum of deposit in the latter's favour or a signed blank share transfer form and a deed of trust in the mortgagee's name. By these means the mortgagor remains the holder of the shares in the register of the company concerned. Although a mortgagee's interest cannot be recorded in a company's share register, it is normal for the mortgagee to inform the company of the deposit of share certificates with them. This usually has the effect of preventing the registration and transfer of the shares without notification to the mortgagee.

Patents, copyrights, goodwill, partnership shares and even interests in trust funds may also be mortgaged. Mortgages of this nature are uncommon though.

Personal security

Personal guarantees are frequently required from directors or principal shareholders, particularly by bankers and major suppliers where the debtor company has not been trading for very long or has a low paid-up capital. Care is needed to ensure the provisions of the Code of Banking Practice and Guidance of the Law Society of Hong Kong are complied with in relation to personal guarantors so as to reduce the risk of challenge later, for example, for undue influence.

It is often advisable for a creditor to require a personal guarantee to be supported by formal security over the guarantor's assets. This is most frequently the guarantor's dwelling house, although the courts are sometimes reluctant to permit this security to be enforced where it involves a family house and the guarantor's spouse claims an interest in the property.

Debentures

A debenture is an acknowledgement of indebtedness by a limited company. It may be either a single debenture in favour of one lender (usually the company's main banker) or a series of debentures or debenture stock which may be bought and sold in the same way as a share in a company. A debenture does not automatically grant security, although most debentures (strictly termed mortgage debentures or secured debentures) are worded so that they do, in fact, secure the indebtedness concerned.

When a series of debentures are issued, it is common for an institution to be appointed as trustee on behalf of the individual holders. The trustee can exercise all the powers of the debenture holders so that his position is similar to that of a single holder. Debentures are widely used to secure overdrafts and loans.

Form of debentures

The debenture is a written document usually sealed by the company creating it, containing an undertaking by the company to repay the sums due on a specified date or on demand. It also commonly includes the following:

- the name of the lender;
- the amount secured and a reference to the interest being charged;
- details of the assets charged, specifying which are subject to a fixed charge and which to a floating charge;
- the lender's rights in the event of non-payment of interest or capital, normally including the right to appoint a receiver; and
- the rights of the receiver to manage and to act on behalf of the company under a power of attorney.

Assets covered by debentures

A company may charge any of its assets, including uncalled capital, goodwill, and future assets. The security given will be subject to either a fixed charge or a floating charge. A fixed charge is a mortgage of specific assets and this is normally restricted to property such as land, book debts and goodwill.

A floating charge is a form of security which is said to "***float***" over various categories of assets, such as machinery, equipment or inventories. It is not fixed because the company is permitted to deal with the charged assets in the ordinary course of business (e.g. by converting its raw material into finished products for sale). New or replacement assets automatically become the subject of the floating charge. The holder of such security is, therefore, able to maintain a charge over all the assets of the company while allowing the company to trade in the normal way.

If a receiver is appointed under the terms of the debenture (usually on the occurrence of any specified event in the debenture deed) the floating charge ***crystallises*** i.e. becomes fixed and all the individual assets covered by the floating charge form part of the fixed security of the debenture holder.

The operation of a floating charge is sometimes difficult for a creditor/supplier to understand, especially if the goods he has recently supplied are deemed to form part of the security of the debenture holder, even though the creditor himself remains unpaid. However a creditor incorporating valid retention of title terms in his contract of supply is entitled to recover his property even where the floating charge has crystallised.

Trust receipts or letters of hypothecation

A trust receipt is a document made pursuant to a pledge to a creditor of goods. A pledge is not complete until there has been actual or constructive delivery of the pledged goods. Once these goods are delivered, they are deemed to be in the possession of the creditor and not the customer. A trust receipt allows possession to be passed back to the customer for purposes of sale without the pledge being defeated. If the goods are then sold, the customer holds the proceeds of sale on trust for the creditor.

Trust receipts are not infallible and do not always protect the position of the creditor. For example, if the goods are processed into something else, the creditor may lose its protection, likewise if the proceeds of sale are co-mingled with other monies. Trust receipts, if properly worded, are not charges and do not require registration under the Companies Ordinance or the Bills of Sale Ordinance.

In theory, letters of hypothecation (as opposed to pledges) do not require the delivery of possession of the goods to be an effective equitable charge. However, letters of hypothecation can be construed as a charge or bill of sale (in the case of individuals) which if not registered are void on the insolvency of the customer.

Receivership

Receivership is a remedy whereby the unpaid holder of a debenture or floating charge appoints a person known as a receiver or receiver and manager to manage the charged assets.

The charged assets commonly comprise the whole (or substantially the whole) of the company's business and assets (subject to the prior rights of other secured creditors and the rights of suppliers under hire purchase, lease or effective retention of title provisions).

The effect of the appointment is that the business and assets are removed from the control of the company and its directors. Other creditors may still petition for the winding-up of the company but this usually does not achieve any useful purpose. Any appointed liquidator is in no better position and has to "wait in the wings" until the receiver has finished his assignment.

The main practical effect of liquidation during the conduct of a receivership is that it terminates the receiver's power to act as an agent of the company, although not all his powers as receiver cease. Thereafter he operates either as principal or as agent for the debenture holder. The debenture holder may thus become liable for the actions of the receiver depending on the terms of the appointing instrument.

Receivership is usually instituted by a creditor holding security. The appointment takes place after making demand for repayment of all banking facilities. Because the receiver has power to trade and dispose of the company's assets as a going concern, it is one of the most important methods by which companies are, in effect, reorganised to enable the business or trade of the insolvent entity to continue.

Although floating charges or debentures may be granted to any creditor to secure indebtedness, in practice they are most commonly used by banks as a means of securing overdraft facilities and other short term lending.

The terms of most debentures and lending arrangements provide for repayment of all advances on demand particularly where the security for the lending is in jeopardy. Failure to pay on demand can result in the almost immediate appointment of a receiver.

Although it may seem drastic for a bank to have these powers, it is usually found that a bank will only take such action when the company is in a terminable condition. The appointment of a receiver is generally in the interest of all creditors because the receiver is normally able to achieve better overall realisations by selling the business as a going concern, than would occur if it was shut down and the assets disposed of piecemeal.

Appointment of a receiver

A receiver is appointed under a deed of appointment usually following formal demand for repayment of the debt. The company has no choice as to the identity of the insolvency practitioner who is appointed. Within seven days of the appointment, notice must be given to the Registrar of Companies for registration (Section 348 Companies Ordinance).

Any appointment is only made after the company has had sufficient opportunity to effect the mechanics of payment. As well as pursuant to a debenture, receivers can also be appointed under fixed charges or mortgages on property or by an order of the court, and the notice of such appointment should likewise be delivered to the Registrar of Companies for registration. For the purpose of the following discussion, we will focus on receivership appointed out of court.

A receiver's powers and duties are based on those contained within the security instrument under which he is appointed. In practice, most debentures taken by banks use a standard and comprehensive form of wording. The debenture is usually expressed to secure "all monies" and not merely a fixed sum.

If the winding up of a company commences within 12 months or two years (as applicable) of the creation of a floating charge granted to secure existing indebtedness, the charge will be invalid except to the extent of any "fresh" or new monies, properties or services being advanced or if it can be proven that the company was solvent at the time of the granting of the charge (Section 267A Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap.32)). This provision serves to defeat attempts by creditors to obtain additional security from companies in financial difficulties, to the detriment of other unsecured creditors.

Receivers' powers

The receivers' powers are determined by the Companies Ordinance and by the mortgage deed or debenture under which the receiver was appointed. It is common for the receiver to have the right to manage the company's assets and to realise them as he thinks fit. Consequently, the receiver will take over the directors' powers of management. If possible, he will continue the company's trade, at least for a short time after his appointment, while he assesses the viability of the business.

Sometimes, when the receiver decides to continue trading for a period, he may for protective reasons, transfer the business and certain tangible assets to a newly incorporated subsidiary company. This process is known as hiving down and does not effect the interests of the company's creditors. Under these arrangements, no consideration for the transfer is paid immediately. It is calculated when, and if, the business and assets are ultimately sold to a third party.

If the receiver sells the business as a going concern, the purchaser normally buys the assets free of any encumbrance or obligation to pay the insolvent company's creditors. Exceptions will be where assets are legally owned by third parties (such as goods supplied from hire purchase, leased or subject to retention of title). In these cases, the receiver will either arrange for the third parties claims to be settled or the obligation transferred to the purchaser with the necessary adjustment to the sale price.

The assets sold by a receiver will normally only extend to tangible assets, goodwill and property rights of the company relevant to enable the business of the company to continue.

The receiver will retain and collect the company's receivables (or book debts) and will separately dispose of any other assets not acquired by the purchaser. The company's employees will commonly be discharged by the receiver and the purchaser may re-employ those members of staff as he requires.

A receiver may apply to the court to sell property charged by a prior charge to someone other than his appointer. If the fixed charge creditor is not going to be paid in full, the receiver needs to show that this course of action is essential to promote a favourable realisation of all the company's assets.

Receivers' obligations

The receiver must notify the company and all creditors of his appointment. In addition, he is required to advertise his appointment and make certain statutory returns. However, he is not obliged to ensure that the company complies with statutory requirements, such as filing annual returns with the Registrar of Companies. These remain the responsibility of the directors.

In cases where the appointed person is receiver or receiver and manager of the whole or substantially the whole of property of the company, a statement of the company's affairs must be made and submitted by officers of the company to the receiver within 14 days of receipt of notice of his appointment (Section 300A Companies (Winding Up and Miscellaneous Provisions) Ordinance) but normally substantial extensions may be granted. The receiver must send this statement to the Registrar of Companies within two months of its receipt (Section 300A Companies (Winding Up and Miscellaneous Provisions) Ordinance).

The receiver is not liable for the debts of the company incurred before his appointment, nor is he bound to adopt any contractual obligations of the company. Where obligations become due after the date of his appointment, providing that he does not adopt the contract under which this liability arises, any such claim merely ranks as an unsecured claim against the company.

The receiver may even exclude personal liability by contract for supplies and services provided to the company. Payment for those supplies and services however, takes priority over the use of any other receivership funds and no reputable insolvency practitioner would leave such supplies unpaid. These payments are commonly referred to as receivership expenses. Creditors should therefore ensure that any goods supplied to a company after an appointment of a receiver are supplied against orders made in the name of the receiver.

A receiver is not required to deal with the claims of the unsecured creditors of the company.

Following the disposal of the assets, the receiver will distribute the net proceeds after taking into account the costs of receivership (including his own remuneration divided between fixed charged assets and floating charged assets).

The receiver pays the net proceeds of the assets covered by the fixed charge, directly to the debenture holder. However, before he delivers the net funds covered by the floating charge, he must first pay the preferential creditors. In practice, liabilities to these creditors are likely to be substantial and the agreement of their claims, particularly those of the Inland Revenue, tend to delay the completion of many receiverships.

The receiver's remuneration is approved by the debenture holder, but it is paid out of the assets of the company, in priority to other claims.

Termination of the receivership

When the receiver has paid the preferential creditors out of floating charge realisations and accounted to the debenture holder for the balance of those assets (if any), any surplus amounts are then paid to the company. Normally by that time, a liquidator would have been appointed and the surplus paid to him. It is not uncommon for an indemnity to be given by the liquidator to the receiver in respect of any unsatisfied claims of preferential creditors.

The receivership is terminated when the debenture holder grants the receiver his release. The receiver must notify the Registrar of Companies when he ceases to act (Section 350(2) Companies Ordinance).

Want to know more?

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