



Taking Securities in Transactions

Important Notice: This article is for general reference only and does not constitute legal advice in relation to any specific case.

Introduction

Clients often come across issues concerning security when negotiating loan or investment deals. This article gives a brief introduction to the ways in which a paying party may secure repayment or promised investment returns or contingent payments by way of security.

In commercial sense, a “security” may be a “security” in its legal meaning, or it may be a “quasi-security”. A real “security” creates an interest in an asset. The asset may belong to the borrower or a third party guarantor.

“Quasi-security”, on the other hand, does not create rights against any asset. It merely creates obligations on the part of a person or company (eg the borrower/ investee or a third party’s) towards the party holding the quasi-security (the lender/ investor).

In this article, the lender/ investor is referred to as the “Lender”, and the borrower/ investee is referred to as the “Borrower”.

Security

Any asset that has a value can be made a security. Assets that are typically used as security include land and buildings, company shares, machines, cash, contractual rights, trading receivables, insurance policies, intellectual property, stock in trade, etc.

In Hong Kong, security typically takes one of the following forms, depending on the subject asset and other circumstances of the transaction:





- **Mortgage** — The Borrower transfers ownership of the secured asset to the Lender to secure repayment.
- **Charge** — The Borrower creates an encumbrance over the secured asset in favour of the Lender.
- **Pledges and liens** — The Borrower transfers possession (but not ownership) of the secured asset to the Lender.

When a company's assets are being made the subject matter of security, a "debenture" may be used to provide a "fixed charge" over specified assets (eg land, machines, etc) as well as a "floating charge" over the other assets not covered by the fixed charge (eg stock in trade). The fixed charge and the floating charge together provide security over all of the assets of the company.

Security may be given by the Borrower itself or by a third party (a guarantor).

Quasi-security

A "quasi-security" provides certain protection to the Lender but it does not actually create any interest in any asset. It is only contractual in nature.

The following are the common types of quasi-security:

- **Guarantee** – A third party (the guarantor) agrees to repay the Lender if the Borrower fails to repay.
- **Indemnity** – A third party agrees to repay as if it is its own primary obligation, even if for whatever reason the Borrower ceases to be obliged to repay. It should be noted that very often a written "guarantee" is in fact an indemnity in terms of legal effect.
- **Performance bond** or **Standby LC** – A third party company or bank commits to pay when a specified event occurs. This is usually supported by a separate arrangement between the Borrower and the third party, eg an indemnity.

Depending on the nature of the transactions supported by them, quasi-securities may also take the forms of, eg, a lease back arrangement, right of set-off, a factoring agreement, etc.

Issues with taking security

Care should be taken to ensure that a security or quasi-security is not void or voidable under the applicable law, eg the Bankruptcy Ordinance (Cap 6), Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32), etc.



Extra care should also be taken when a third party gives a security or quasi-security. For example, in some circumstances, a personal guarantee (even one given by a borrower company's director) may have been obtained under undue influence and is therefore voidable by the guarantor.

In the context of financial or commercial transactions, there should be commercial reasons for a third party to provide security or quasi-security, and the process through which the security or quasi-security is obtained should be handled with due care.

In a share acquisition deal, illegal financial assistance to the buyer of the shares must not be given by the company, otherwise a criminal offence may be committed under the Companies Ordinance (Cap 622).

For enquiries, please contact us.

Tony Au & Partners

**Office: Room 1808, 18/F, Tower One, Lippo
Centre, 89 Queensway, Hong Kong.**

Tel: (852) 2530 0391

Fax: (852) 2530 0367

Email: mail@tony-au.com

Website: www.tony-au.com

