

# Article

Substance v/s Form Conflict in True Sale | Hong Kong  
Court goes by the language used by the Parties

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### **NBFCs upbeat**

In every assignment transaction, there has been a constant conflict of whether the substance or form shall dominate while determining the nature of a transaction. There are two schools of thought in this: one which gives dominance to substance over form and the other which prefers the dominance of intention that is expressed rather than that not expressed, i.e. prefers the form over substance.

Generally speaking, when the nature of a transaction goes for determination, while respecting the intention of the parties set out in the documents, it shall be preferable to probe into the substance of the transaction rather than the plain label and language used so as to decipher what actually the transaction is all about. As has been said by many, language as an indicator is good but cannot be a determinant.

Recently, the Hong Kong High Court in an insolvency law matter has followed the form over substance and held a transaction as a sale, even though, as is discussed hereunder, the elements of a sale transaction were absent.

The case which the author is analysing is the case of *Hallmark Cards Incorporated v. Yun Choy Limited and the Standard Chartered Bank (Hong Kong) Limited*<sup>1</sup>, where the document in question was the Receivables Purchase Agreement (“RPA”) in relation to which the issue was the famous *substance v. form* conflict. The key discussions and the decision of the Hong Kong Court are summarized hereunder:

#### **1. Arguments of the Liquidator of the Company (i.e. Yun Choy Limited)**

- 1.1 The liquidators of the Company argued that (a) the transaction amounted to lending secured by a charge on the book debts of the Company; (b) since the charge is not registered, the same is invalid; (c) the transaction amounted to a general assignment of book debts and hence void by reason of non-registration under the applicable bankruptcy laws of Hong Kong.
- 1.2 The liquidators harped on the substance of the RPA arguing that even though the transaction was expressed as a sale and purchase of the debts due from the Company’s customers, in substance it was an assignment by way of security

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<sup>1</sup> [2012] 1 HKLRD 396



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creating a fixed charge over the book debts and not an out-and-out sale of book debt.

1.3 The Company retained the risk of non-repayment of debt by a customer. Hence, there was no transfer of risk, which is one of the essentials of a true sale transaction.

1.4 In the transaction:

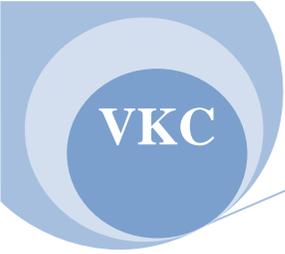
- (a) In a termination event, the Company could be required by the Bank to purchase all the outstanding debts and the sum of the funds in use, which, as argued, would essentially be the repayment of the outstanding loan;
- (b) The Bank had to account to the Company and the Company could recover the full value of its book debts, i.e., if the payment by the Company's customers to the Bank exceeds the sums debited in the factoring account, the credit balance would be payable to the Company;
- (c) In case of a shortfall, the Bank was entitled to recover the balance from the Company;
- (d) There was no fixed price for the purchase of a debt

1.5 It was, therefore, argued that the elements set out in the case of *In re George Inglefield Ltd.*<sup>2</sup>, were satisfied in the transaction, and hence, the same would not amount to a sale but a mortgage. This *George Inglefield* case has set out clear differences between a true sale and a mortgage:

Basis	True Sale	Mortgage
No recourse	Seller is not entitled to get back the asset sold by returning the money to the purchaser.	Mortgagor is entitled, until he has been foreclosed, to get back the asset by returning the money to the mortgagee.

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<sup>2</sup> [1933] Ch 1



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<b>Basis</b>	<b>True Sale</b>	<b>Mortgage</b>
Account of profit on sale of asset	The purchaser does not have to account the seller of any profit realized by sale of the asset purchased from the seller.	Any amount realized in excess of the amount sufficient to repay the mortgagee shall be accounted back to the mortgagor.
Right to receive the shortfall	The purchaser cannot recover from the seller any amount which upon resale of the purchased property was insufficient to recoup the money paid to the seller.	A mortgagee is entitled to recover from the mortgagor the difference between the amount from sale of asset and the amount due from the mortgagor, if the amount from the sale of asset is insufficient to meet such amount due.

The author submits that looking at the clauses in the RPA, it could be validly argued that the principles of a true sale transaction (which has been discussed in detail by the author in this article) was missing and looking at the substance, it may not appear as a true sale.

### **2. Arguments of the Bank (i.e. the Standard Chartered Bank)**

#### **2.1 The Bank argued that:**

- (a) The Company's entitlement to be paid the credit balance in the factoring account did not amount to an equity of redemption.
- (b) There is nothing wrong in a sale of debt for the purchase price to be fixed by the amount to be collected by the purchaser later.
- (c) A sale with recourse is still a sale.

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2.2 In support of its argument, the Bank relied on two famous cases of *Welsh Development Agency v. Export Finance Co Ltd*<sup>3</sup> and *Orion Finance Ltd v. Crown Financial Management Ltd*<sup>4</sup>.

- (a) In the *Welsh Development* case, the Court had held a transaction to be sale even though the same apparently looked like a financing transaction but was documented as a sale, setting out the following principles of determination:
  - (i) If the words in different parts of the document point in different directions, then the agreement shall be looked at as a whole and its substantial effect shall be seen.
  - (ii) Looking at the substance apart from looking at the language used by the parties may not be necessary as it is only by a study of the whole of the language that a substance can be ascertained.
  - (iii) It is entirely beyond the function of a Court to discard the plain meaning of any term in the agreement unless there can be found within its four corners other language and other stipulations which necessarily deprive such term of its primary significance.
  - (iv) Factoring or block discounting amounts to a sale of book debts, rather than a charge on books debts, even though under the relevant agreement the purchaser of the debts is given recourse against the vendor in the event of default in payment of the debt by the debtor.
  - (v) There may be a sale of book debts, and not a charge, even though the purchaser has recourse against the vendor to recover the shortfall if the debtor fails to pay the debt in full; and the purchaser may have to make adjustments and payments to the vendor after the full amounts of the debts have been got in from the debtors.
  
- (b) Further in the *Orion Finance* case, the Court had said that

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<sup>3</sup> [1992] BCLC 148

<sup>4</sup> [1996] 2 BCLC 78

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- (i) The question to be determined is not what the transaction is but whether it is in truth what it purports to be.
- (ii) Unless the documents taken as a whole compel a different conclusion, the transaction which they embody should be categorized in conformity with the intention which the parties have expressed in them.

### 3. Verdict of the Hong Kong High Court

The High Court held in favour of the Bank saying the arguments advanced were on the agreement of sale, while those of the Company were on the economic effect of the RPA. The transaction was held as a sale.

### 4. Analysis of the decision

The Hong Kong High Court did not give the basis of holding the transaction as a sale and neither did it discuss the parameters of a sale transaction. This case is a clear case of a form over substance ruling.

However, looking at some of the factors of a sale, it cannot be said that the transaction was a sale. The basis on which the author holds this view are discussed below:

#### 4.1 *Going the US way – substance over form approach*

In the United States, the Courts have normally refused to go by the label of the contract and rather look into the nature of the agreement. One important aspect to be seen, which was elaborated in the case of *Major's Furniture Mart v. Castle Credit Corp*<sup>5</sup>, is whether the risks have been retained by the seller. In this the *Major's Furniture* case the Court had said that it shall be seen whether the nature of recourse is such that the legal rights and economic consequences of the agreement bear a greater similarity to a financing or a sale transaction.

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<sup>5</sup> 602 F.2d 538 (3d Cir. 1979). This is one of the most cited cases when determining a *sale v. financing* question.

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Therefore, primarily, the US Courts have preferred a substance over form approach, which is different from the form over substance which the UK Courts have preferred.

### 4.2 *Revocable Transaction*

If the transaction is revocable, i.e. presence of a repurchase agreement has the effect of being treated as a secured borrowing.

### 4.3 *Failure of the transaction to satisfy the determinants for a true sale transaction*

#### (a) *No recourse against the seller*

The risks and rewards shall be transferred by the seller to the buyer, thereby eliminating a possibility of any recourse against the seller. This is primarily a negative attribute and may not in itself be a determinant factor as recourse is like a warranty given by the seller on the quality of the assets sold.

The transaction for determination before the Hong Kong gave the Bank a recourse against the Company, inspite of which the transaction was upheld as a sale. The Hong Kong High Court accepted the Bank's contention that even though there may be recourse against the seller, a transaction could be sale.

#### (b) *Retention of residual interest by the seller*

In a sale transaction, the seller cannot have control on profits of the buyer that arise after the sale. This was also clearly highlighted in the *George Inglefield* case by the liquidator of the Company. As has been stated, the rewards shall also stand transferred along with the risk in a sale transaction.

#### (c) *Uncertain sale consideration*

Where the amount of sale consideration is not ascertained or fixed, it cannot be said to be a sale transaction. This factor makes the transaction move closer to a financing transaction.



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### **5. Conclusion**

The tendency of the UK Courts and those following the UK principles to accept the language of the contract as the primary indicator of substance continues. The ruling does not help resolving the substance v. form conflict, which still continues as an unresolved debate.