NOTES OF CASES

DUTIES OF A MORTGAGEE WHEN EXERCISING HIS POWER OF SALE

Tse Kwong Lam v. *Wong Chit Sen & Others*[1]

THE decision is of the Judicial Committee of the Privy Council dealing with an appeal from the Court of Appeal of Hong Kong. The facts are uncontroverted. The appellant (Mortgagor), was in the construction business and had built a 15 storey building containing 90 shops, office and flat units. To finance this project, he had conducted advance sales of 36 units and borrowed HK$1.4m on the security of a mortgage, by way of a legal charge dated 30 November 1963, over the remainder of the building from the 1st respondent, Wong Chit Sen, (the Mortgagee). On 28 February 1966, the mortgagee sent a notice to the mortgagor informing him that unless certain arrears of interest were paid by 29 March 1966, the mortgagee would exercise his power of sale. A further notice was sent but the mortgagor failed to comply with either notice. Thereupon, the mortgagee arranged for the property to be sold by public auction on 24 June 1966. This was advertised in 3 newspapers on 3 separate days, the first of which appeared on 9 June 1966, which gave notice of the auction and a minimal description of the property. The particulars and conditions of sale contained only the bare legal requirements. They stated *inter alia,* that (i) there was to be a reserve price; (ii) that the vendor reserved the right to bid; (iii) that 20 per cent of the purchase price was payable immediately after the auction and the balance was payable a month thereafter time being of the essence. The mortgagee without consulting the auctioneer or any estate agent fixed the reserve price at HKS1.2 million. The mortgagee was minded to sell the property to Chit Sen Co. Ltd. a company of which the mortgagee, his wife (the 2nd respondent) and son were the only directors and shareholders of the company at the time of sale. During a board meeting, on 20 June 1966, the members of the company agreed that the 2nd respondent would bid up to HKS1.2 million for the property at the auction. This was done at the auction held on the 24 June 1966 and as the 2nd respondent was the only bidder, the property was knocked down to her. The mortgagee advanced the HK1.2 million to the company by way of an interest free loan and the latter repaid that sum to the mortgagee for the transfer of the property to it. The mortgagee started an action to claim HK$400,000 from the mortgagor as being an outstanding sum after the payment of HKS1.2 million to him. The mortgagor disputed this and counterclaimed to set aside the sale on the ground that the sale was improper and at an undervalue. On May 1979, Zimmern J. of the Hong Kong High Court gave judgement for the mortgagor in his counterclaim, but refused to set aside the sale because of the lapse of time due to delay by the mortgagor in the counterclaim suit. The mortgagees appeal to the Hong Kong

[1] (1983) 3 A.E.R. 54.

Court of Appeal was allowed. The Privy Council allowed the mortgagors' appeal and directed an order on the same lines as that of Zimmen J.

The judgment of the Privy Council was delivered by Lord Templeman, who after stating the relevant facts above said that a mortgagee was not a trustee of the mortgagor when exercising his power of sale by citing[2] the noted statement of Kay J. in *Warner* v. *Jacob*[3] who said:

> ... a mortgagee is strictly speaking not a trustee of the power of sale. It is a power given to him for his own benefit, to enable him the better to realize his debt. If he exercises it *bona fide* for that purpose, without corruption or collusion with the purchaser, the court will not interfere even though the sale be very disadvantageous, unless indeed the price is so low as in itself to be evidence of fraud.

This merely restates the traditional view that a mortgagee need only act in good faith and in the absence of fraud he is not liable to account to the mortgagor for any loss to the latter and therefore, there is no possibility of setting aside the sale. The reason for this is that the mortgagee by virtue of his contract with the mortgagor has his own interests to look after and it is felt by the judges that there would be sufficient protection to mortgagors by merely limiting the mortgagee's duty to one of good faith and not to act fraudulently.[4] Hence in the absence of *mala fides* the sale could not be set aside merely because if the property had been sold at a later date, a higher price could have been realized.[5] Moreover, the court is not concerned about the motives of the mortgagee when exercising his power of sale provided that the sale is conducted properly, at a fair value and is not a sale to himself.[6] The present case goes further and reaffirms the "dual" duty role adopted by the Court of Appeal in *Cuckmere Brick Co. Ltd.* v. *Mutual Finance Ltd.*[7] There in addition to the duty of good faith, Salmon L.J. held that

> ... both in principle and authority,... a mortgagee in exercising his power of sale does owe a duty to take reasonable precautions to obtain the true market value of the mortgage property at the date on which he decides to sell it. No doubt in deciding whether he has fallen short of that duty the facts must be looked at broadly and he will not be adjudged to be in default unless he is plainly in the wrong side of the line.[8]

This modern trend towards a dual approach is in the opinion of this writer desirable for 2 main reasons. First, the concept of "good faith" alone as a guideline for future decisions is rather nebulous, because the impression one gets is that apart from fraud and collusion an act would satisfy this requirement. Secondly, it suggests that negli-

2 *Ibid.,* p. 586.
3 (1882) 20 Ch. D. 220 at 224.
4 See *Kennedy* v. *De Trafford* (1897) A.C. 180.
5 *Davey* v. *Durrant* (1857) 1 De Gef 537.
6 *Nash* v. *Eads* (1880) 25 Sol Jo. 95; *Belton* v. *Bass, Ratcliffe* and *Gretton Ltd.* (1922) 2 Ch. 449.
7 (1971) 1 Ch. 949.
8 *Ibid*., at pp. 968H-969A. He also explained at p. 968 the judgements, of *Lindley L.J.* in the Court of Appeal in *Kennedy* v. *De Trafford* (1896) 1 Ch. 762 at 772 and *L. Herschell* in the House of Lords (1897) A.C. 180 at 185.

gence in the conduct of the sale on the part of the mortgagee or his agent, subject to *bona fides* being established, would be insufficient for liability which is clearly not so.[9]

Although it is conceivable that one may construe the words "good faith" in such a manner as to include a role of taking "reasonable precautions to obtain the true market value",[10] it is better to spell out and define the two duties as this would make it easier for subsequent judges to apply, and would provide adequate protection to the mortgagor. Neither would this 'extension' of the mortgagee's duty be too harsh towards a purchaser from the mortgagee who had bought without notice because of the provision in a section 26(2)[11] Conveyancing and Law of Property Act which in effect tells the mortgagor to turn towards the defaulting mortgagee for his damages action. It should be noted that the burden of proof is on the mortgagor to prove breach of the duty by the mortgagee.[12]

Sale by Mortgagee to a company of which he is a shareholder

This was the main issue which the Privy Council had to deal with. It is clearly established that a mortgagee cannot sell to himself and this is so even though the purchase price reflects the "true value" of the property sold. Quite apart from the conflict of interest and duty, it also affronts a basic contract principle that a person cannot make an agreement with himself. Moreover the mortgagee is not absolved from liability by using an agent or trustee to buy for him as Equity looks not at the form but the substance of the sale.[13]

This principle is also extended to a case where a solicitor or agent employed by the mortgagee to conduct the sale, purchases the property.[14] However, as in the present case, a sale by a mortgagee to a corporation of which he is a member, i.e. a shareholder, or, conversely a sale by a mortgagee corporation to its members or director is not, without more, invalid so as to justify a setting aside of the sale or making the mortgagee concerned liable in damages. This was held to be so in *Farrar* v. *Farrars Ltd.*[15] where a solicitor, who was one of three mortgagees acted in that capacity and sold the mortgaged property to a company formed for the purpose of purchasing it. The solicitor then took shares in this company. It was held by the Court of Appeal affirming Chitty J.'s judgment that the mortgagee was not at fault in so doing as he had taken reasonable steps to secure a purchaser at the best price. In answer to the appellant mortgagor's contention that it was in substance

9 See the *Cuckmere* decision, *supra,* n. 7.

10 See *Walsh J.* in *Forsyth* v. *Blundell* (1973) 129 C.L.R. 477 at 481 (High Court of Australia).

11 Cap. 268, 1970 Edition: But the position is different if the purchaser has actual knowledge of a defect in the mortgagee's exercise of his power of sale, or if he became aware "of ... any facts showing that the power of sale is not exercisable, or some impropriety in the sale" — *per* Gossman J. in *Lord Waring v. London & Manchester Co. Ltd.* (1935) Ch. 310, 318; also *Selwyn* v. *Garfitt* (1888) 38 Ch. D. 273.

12 *Haddington Island Quarry Co. Ltd.* v. *Hudson* (1911) A.C. 727.

13 *Downes* v. *Glazebrook* (1817) 3 Mer 200; followed by the Court of Appeal in *Farrar* v. *Farrar's Ltd.* (1888) 40 Ch.D. 395.

14 *Martinson v. Clowes* (1882) 21 Ch.D. 857; but not if the agent was not employed in the conduct of the sale: *Guest* v. *Smythe* (1870) L.R.; also *Hodson* v. *Deans* (1903) 2 Ch. 647.

15 (1888) 40 Ch.D. 395 (C.A.).

a sale by a mortgagee to himself and others under the guise of a sale to a limited company, Lindley L.J. said [16]

> A sale by a person to a corporation of which he is a member, is not, either in form or in substance, a sale by a person to himself. … But although this may not be reached by the rule which prevents a man from selling to himself or to a trustee for himself. Such a sale may be fraudulent and of an undervalue or it may be made under such circumstances which throw upon the purchasing company the burden of proving the validity of the transaction, and the company may be unable to prove it.

This approach in dealing with the relationship between mortgagees and a corporation in the context of an exercise of the power of sale by a mortgagee is palatable in that it recognizes the separate legal personality of a corporation yet at the same time it does protect mortgagors from "sham transactions" because in such cases once a mortgagor has shown that there is a conflict of duty and interest on the part of the mortgagee and the "circumstances warrant it," the burden of proving the validity of the transaction is shifted to the mortgagee and/or the purchasing corporation.[17] Presumably the mortgagee will be able to save the transaction if he shows that reasonable precautions were taken to obtain the true market value of the property concerned. A further safeguard to the mortgagor is that the transaction is also covered by the fraud rule.

The decision is *Farrar's* case gives a wide discretion to the judge when dealing with such transactions, and the present case adopts the same view, as *Lord Templeman* after citing the passage by Lindley L.J. in *Farrars* case [18] said

> … on authority and principle there is no hard and fast rule that a mortgagee may not sell to a company in which he is interested. The mortgagee and the company seeking to uphold the transaction must show that the mortgagee took reasonable precautions to obtain the best price reasonably obtainable at the time. The mortgagee is not however bound to postpone the sale in the hope of obtaining a better price or to adopt a piecemeal method of sale which could only be carried out over a substantial period or at some risk of loss.[19]

In *Tse Kwong Lam,* the Privy Council had little difficulty in coming to the conclusion that the transaction was irregular. It noted (i) the close relationship between the mortgagee and the purchasing company; (ii) the mode and manner in which the sale was conducted in particular the lack of consultation with the auctioneer and any estate agent; (iii) the amount of HK$1.2 million that was fixed as the reserve price; (iv) the lack of and/or inadequate explanation given by the mortgagee and the purchasing company. It is interesting to contrast the present case with *Farrar's* case,[20] where the burden

16 *Ibid*., at pp. 409-410.
17 This is unlike the case of a mortgagee selling to an independent purchaser see *supra,* n. 12.
18 See *supra,* n. 16.
19 (1983) 3 A.E.R. 54, 59.
20 See *supra,* n. 15; also *Hodson* v. *Deans, supra,* n. 14. Sale by auction by a mortgagee Friendly Society to one of its trustees who had been involved in conduct of the sale: sale set aside.

was successfully discharged by the mortgagee solicitor who had taken all reasonable precautions to obtain the true market value. There the court noted that the mortgagee failed to obtain professional valuation but was persuaded by the fact that they had taken a valuation of the property a few years previously. In addition, there was also an attempted sale of a neighbouring stone quarry, which also had been mortgaged to the same mortgagees; and this gave an adequate yardstick as to the valuation of the mortgaged property in the case. Further it should be noted that in the earlier case the agreement of sale preceded the formation of the company and the subsequent conveyance to it was "merely formal work consequential on the previous agreement".[21] In the case at hand, the purchasing company was already in existence at the time of the agreement to purchase and this may lead to greater suspicions by the court.

Remedies

There are a number of remedies at the mortgagor's disposal to prevent or rectify an irregular exercise of the power of sale. First, there is the right to go before the court for injunctive relief restraining the mortgagee and purchaser from completing the sale. However the instances when it is granted are limited. This will be so when fraud is proved, or it has been established that the purchaser has actual notice of the irregularity in the exercise by the mortgagee of the power of sale,[22] Further, an injunction would be granted if before there is a contract for sale, the mortgagor tenders to the mortgagee or pays into court the amount due.[23] Secondly, the mortgagor may apply for an order setting aside the sale. Again this will only affect a purchaser who has actual notice of the irregularity of the sale for otherwise the purchaser is protected by the provisions of section 26(2) Conveyancing & Law of Property Act.[24] In the present case, the mortgagor could have obtained such an order setting aside the sale as it is clear that the purchasing company knew of the "improper exercise" of the power of sale by the mortgagee. However the Privy Council felt there was "inexcusable delay" in the mortgagor prosecuting his counterclaim. As Lord Templeman said:[25]

> The borrower by his delay achieved a favourable position, if the property decreased in value he could either abandon his action or seek damages in setting aside the sale. If the property increased in value he could persist with his claim to set aside the sale.

On the facts there was a lapse of 13 years between 15 December 1966, the date of the counterclaim and 15 May 1979 when Zimmern J. delivered his judgment that the price paid was not a proper price. The Privy Council was moved by the fact that the mortgagee and the purchasing company would have been put in expense for maintenance and repairs to the building and therefore the sale was not set aside. This leads us to the third remedy, namely damages to recompense the mortgagor, and this was so was decreed in the present case. The measure of damages would be the difference between the best price reasonably obtainable on 24 June 1966 (the auction date) and the

21 *Per* Lindley L.J. in *Farrar* v. *Farrars* Ltd. in *supra,* n. 15 at p. 414.
22 See *supra,* n. 11.
23 *Warner* v. *Jacob,* see *supra,* n. 2.
24 See *supra,* n. 11.
25 See *supra,* n. 1 at p. 63.

price of HKS1.2 million paid by the purchasing company. This method is suitable for an auction sale as in such sales there is no sale price fixed beforehand. However, for the quantification of damages in sales by private treaty the relevant date to work from is the date when the agreement to sell was made because that is the time the mortgagee has chosen to sell the property and if at that time the true value was not obtained, then the mortgagee should be made to pay for the short-fall. It seems unfair to allow a mortgagee to take advantage of an increase in the value of the property between the date of the agreement and the date of the conveyance as the latter is a formality.

Conclusion

The decision in *Tse Kwong Lam* has reaffirmed the existing principle that governs a mortgagee's exercise of his power of sale namely that he is not a trustee of that power. However he is under a duty to act in good faith and also to take reasonable precautions to obtain the true market value. The mere fact that the sale was to a corporation of which a mortgagee is a member or director does not by itself entail a breach of duty on his part. But if the circumstances show a conflict of interest and duty, then the onus lies on the mortgagee to show that he had taken whatever "reasonable steps" necessary to support the validity of the sale.

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