

Note

WHEN IS AN ELEPHANT A BIRD?

This note discusses the House of Lords decision in *National Westminster Bank plc v Spectrum Plus Ltd* [2005] 2 AC 680 and the Singapore High Court decision in *Cheah Geok Tuan v Lie Khin Sin* [2006] 1 SLR 340 in the context of when a transaction, particularly one ostensibly involving a sale and repurchase agreement, would be characterised instead as a loan. It is suggested that that lawyers giving true sale opinions to structures that have a borrowing or lending effect must now quite often qualify those opinions or at least word them more conservatively because it is a question of fact whether a transaction is viewed as a sham or pretence. Quite often, policy considerations dictate how closely a court scrutinises the surrounding circumstances, including post-contractual evidence.

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I. Introduction

1 This note does not seek to revisit the fixed versus floating charge debate which was revived by the House of Lords in *National Westminster Bank plc v Spectrum Plus Ltd*¹ (“*Spectrum*”) that was ably discussed by Associate Professor Dora Neo and Mr Lee Eng Beng in the September 2005 issue of the *Singapore Academy of Law Journal*.² However, in

1 [2005] 2 AC 680 (“*Spectrum*”).

2 See, respectively, Dora Neo, “Fixed and Floating Charges Over Book Debts: A Post Mortem on the Debate” (2005) 17 SAclJ 617 and Lee Eng Beng, “Surviving *Spectrum Plus*: Fixing Charges Over Debts: *In re Spectrum Plus Ltd* [2005] 3 WLR 58” (2005) 17 SAclJ 932. One thing that was not discussed by them is the implication that *Spectrum* has for the decision of our Court of Appeal in *Asiatic Enterprises (Pte) Ltd v United Overseas Bank Ltd* [2000] 1 SLR 300 which held that where a clear mechanism is provided, an agreement to give a charge could be effective in creating a security interest, and not only contractual rights. According to Lord Scott in *Spectrum, id*, at [107]: “There can, in my opinion, be no difference in categorisation between the grant of a fixed charge expressed to come into existence on a future event in relation to specified class of assets owned by the chargor at that time and the grant of a floating charge over the specified class of assets with crystallisation taking place on the occurrence of that event.” This supports the decision of Tay Yong Kwang JC (as

discussing the local decisions on whether a sale and repurchase agreement amounts to a loan, it is unavoidable that often involved reference is made to some of the speeches of the Law Lords there, and in particular to the questions left unanswered by that case, which sanctioned the examination of post-contractual or post-creation events to determine whether security given by a company to a bank is fixed or floating in nature. This is problematic because it has been said, for example, by Lord Reid that “it is now well settled that it is not legitimate to use as an aid in the construction of a contract anything which the parties said or did after it was made”.³ Post-contractual evidence was usually inadmissible and yet after *Spectrum* it appears that the reverse is now true, which is the important point made by Alan Berg in his recent article in the *Journal of Business Law*.⁴

II. *Cheah Geok Tuan v Lie Khin Sin*

2 The aim of this piece is more modest. Its focus is the judgment of Choo Han Teck J in *Cheah Geok Tuan v Lie Khin Sin*⁵ (“*Cheah*”), where the learned judge prefaces his judgment by asking: “When is an elephant a bird?”⁶ In so describing the issue of whether a sale and repurchase should be characterised as a loan, he reminds us of what Lord Templeman said in *Street v Mountford*⁷ when holding that a grant of “exclusive possession for a term at a rent” is a lease:⁸

If the agreement satisfied all the requirements of a tenancy, then the agreement produced a tenancy and the parties cannot alter the effect of the agreement by insisting that they only created a licence. The manufacture of a five-pronged implement for manual digging results in

he then was) at first instance in *United Overseas Bank Ltd v The Asiatic Enterprises (Pte) Ltd* [1999] 4 SLR 226 where he held that the arrangement resulted in a floating charge. See further Lee Eng Beng, “Invisible and Springing Security Interests in Corporate Insolvency Law” (2000) 12 SAclJ 210; Victor Yeo, “No Security for the Unsecured Creditor – *The Asiatic Enterprises (Pte) Ltd v United Overseas Bank*” (2000) 12 SAclJ 218 and Tan Cheng Han, “Springing Security Interests and Registration” (2001) 13 SAclJ 451.

3 *Whitworth Street Estates (Manchester) Ltd v James Miller & Partners Ltd* [1970] AC 583 at 603.

4 Alan Berg, “The Cuckoo in the Nest of Corporate Insolvency: Some Aspects of the *Spectrum* Case” [2006] JBL 22. See also Stephen Atherton & Rizwaan Jameel Mokal, “Charges Over Chattels: Issues In The Fixed/Floating Jurisprudence” (2005) 26 *Company Lawyer* 10.

5 [2006] 1 SLR 340. The Court of Appeal dismissed the appeal (Civil Appeal No 132 of 2005) without written grounds.

6 *Id.*, at [1].

7 [1985] AC 809.

8 *Id.*, at 819.

a fork even if the manufacturer, unfamiliar with the English language, insists that he intended to make and has made a spade.

The imagery utilised by Choo J is, however, perhaps more nuanced than the inanimate garden tools utilised by Lord Templeman. Is an elephant considered a bird because it looks like a bird, or because it acts like one?

3 In *Cheah*, there was in May 2001 a purported sale of shares at \$255,000 with a buyback option attached to it. The seller was to repurchase the shares at \$297,750 on a stipulated date in August 2001 (which worked out to an additional sum of \$15,000 per month, and this was also the rate payable for any extension of the option). The seller also had to pay stamp duties on the transfers of shares. In addition, dividends and bonus shares were to accrue to the seller. Payment for the shares was made to the seller's husband (for use in his business), and the argument raised in court by the seller and her husband was that this was a third party loan secured on the seller's shares.

4 The most important point to note is that this was an *inter partes* dispute, not involving third parties, which arose because the shares were subsequently worth more than the agreed upon redemption amount or repurchase price (which was settled by the seller's husband and the buyers at a price of \$450,000 in September 2004 because the seller and her husband had for almost three years failed to pay the required "interest" or the price for extending the option, after having done so for the first six months after the agreement had come into force). The seller claimed the shares back on the basis that it had agreed to redeem the loan. The buyers, who were father and son (the financing was arranged by the son, and the shares were also transferred into his name) claimed, on the other hand, that the shares were held on trust for an Indonesian financier that had provided the purchase money. Rejecting the last submission,⁹ Choo J held that the transaction was a loan with interest payable at 20% per annum as permitted by the Moneylenders Act.¹⁰ Consequently, the buyers had to deliver up the share scrips to the seller's husband on payment of the principal plus interest.

5 While it is possible that title to shares can pass back to the seller where payment has been tendered under a repurchase agreement,

⁹ *Supra* n 5, at [18] and [21].

¹⁰ Cap 188, 1985 Rev Ed. Section 23(5) prescribes the maximum rate of interest that can be charged by a person who is not a moneylender or within a list of specified persons including banks and finance companies.

perhaps even where it is not specifically enforceable,¹¹ that difficult question did not have to be addressed as Choo J found that the buyers had only extended a loan to the seller and her husband. While not expressly discussed in the case, the parol evidence rule was not an issue as it was clear that the agreement was based on a contract that was both partly oral and partly written.¹² In any case, the documentation itself contained terms that were alien to a sale and repurchase. For one, the seller had to pay stamp duties (indeed it was, on the buyers' instructions, stamped for a much higher amount than the actual transfer value in order to avoid the scrutiny of the tax authorities) and also retained the dividends and bonus issues even though the shares were prior to repurchase registered in the buyer's name.¹³ Further, the buyback price and the extra amount payable for extending the option appeared to Choo J very much like monthly interest payments, which was how the parties described it during pre-contractual negotiations.¹⁴

6 These inconsistencies were gleaned from the documentation itself, which had been labelled "a purchase of shares with a buyback option".¹⁵ However, Choo J went on to examine other evidence, including post-contractual actions of the parties, particularly the events surrounding how the parties came to settle on the redemption amount in September 2004, which were more than three years after the contract was made. While Choo J stated that post-contractual evidence had no bearing on the nature of the agreement, thus strictly not offending the old principle that such evidence cannot be used to aid the construction of a document, he held that it indicated the state of mind of the parties concerned,¹⁶ and this buttressed the characterisation of the transaction as

11 *Chinn v Collins (Inspector of Taxes)* [1981] AC 533 at 548, where Lord Wilberforce said that, "dealings related to the equitable interest in these [shares] required no formality. As soon as there was an agreement for their sale accompanied or followed by payment of the price, the equitable title passed at once to the purchaser ... and all that was needed to perfect his title was notice to the trustees or the nominee ...". Cf *Oughtred v Inland Revenue Commissioners* [1960] AC 206.

12 See further Elizabeth Peden & JW Carter, "Entire Agreement – and Similar – Clauses" (2006) 22 JCL 1; cf *Formet Enterprise Co Ltd v Howell Universal Pte Ltd* [2006] 2 SLR 349. The parol evidence rule is found in s 93 of the Evidence Act (Cap 97, 1997 Rev Ed).

13 In *Thai Chee Ken v Banque Paribas* [1993] 2 SLR 609, which is discussed in detail later at para 23 of the main text below, the seller also paid the stamp duties but the agreement was silent on who was to receive the dividends. The Court of Appeal held that it was a sale and repurchase agreement.

14 *Supra* n 5, at [17].

15 *Id.*, at [21].

16 *Id.*, at [22].

a loan. Choo J concluded by saying that “[a]n elephant is a bird when it has feathers and can fly”.¹⁷

7 While both the agreement and post-contractual evidence of intention here pointed to the transaction being a loan, it is suggested that there is some profit to be gained from examining in greater detail what Staughton LJ referred to in *Welsh Development Agency v Export Finance Co Ltd*¹⁸ (“*Exfinco*”) as the internal and external routes of characterising a transaction, even if it only serves to confirm Berg’s suspicions, drawn from *Spectrum*, that there should be no distinction between them.¹⁹ There may be instances where the initial appearance and subsequent conduct by the parties do not match, and in those situations post-contractual evidence may do more than simply confirm the parties’ intentions at the time of contracting, particularly where the interests of third parties are involved. Where external concerns are involved, policy considerations would be relevant in determining how a transaction is characterised (such as in the case of the Rent Acts which was often at the heart of the lease/licence debate in England). Some would argue that this is tantamount to a form of (re)characterisation,²⁰ something which Choo J did not have to deal with as *Cheah* was strictly a two-party case. At the end of this article, we will re-examine two older cases in Singapore where third party interests were at stake, and yet where sale and repurchase agreements were found to be such, even though arguments were raised that they were really secured loans.

III. Internal and external routes to (re)characterisation

8 The problem lies in the use of the language of form and substance. At first blush, it makes sense to say that courts should and can look at the substance of the matter.²¹ What, however, is this? Are we referring to the parties’ subjective intentions, or what is reflected in the documentation, or the economic function of the transaction, or a court’s objective view of their intentions as played out in their actions? In the

17 *Id.*, at [23].

18 [1992] BCLC 148 at 186–187.

19 Berg, *supra* n 4, at 36 *et al.*

20 While speaking of “recharacterisation” may not be strictly accurate, as it can be argued that what is in fact happening in many of these cases is simply more precise characterisation, it is a phrase that was used extensively by the English Law Commission in its Consultation Paper CP 164, *Registration of Security Interests: Company Charges and Property other than Land* (June 2002) at paras 6.8–6.10 and 6.34–6.35.

21 See, *eg.* *In re George Inglefield Ltd* [1933] Ch 1 (CA).

latter case, are we looking at it purely evidentially, as Choo J appeared to do in *Cheah* or do we more formally recharacterise the transaction because it is a sham or pretence? Further, in the later instance, is the transaction characterised retrospectively, or only varied for the future? As Staughton LJ said in *Exfinco*:²²

The problem is not made any easier by the variety of language that has been used: substance, truth, reality, genuine are good words; disguise, cloak, mask, colourable device, label, form, artificial, sham, stratagems and pretence are 'bad names', to adopt the phrase quoted by Dixon J in *Palette Shoes Pty Ltd v Krohn* (1937) 58 CLR 1 at 28.

9 In *Exfinco*, the English Court of Appeal expressly said that it was only concerned with the four corners of the agreement, as it was not pleaded that the transaction was in any way a sham. This involved sales by Parrot, an exporter of floppy disks for computers to overseas buyers. However, to obtain financing for its exports, Parrot would first sell the goods to Exfinco, which kept a fund of 10% of the price of goods sold to meet future obligations of Parrot. Exfinco retained title to the disks till payment by an overseas buyer, and the overseas buyer would pay the purchase price into Parrot's bank account that was exclusively controlled by Exfinco.

10 At first instance,²³ Sir Browne-Wilkinson VC held that the arrangement created a loan secured by a charge over the floppy disks as it was not possible to say with any certainty whether Parrot had contracted with overseas buyers as principal or as agent for an undisclosed principal (there was a question as to whether the goods satisfied all the warranties at the time of the sale by Parrot to Exfinco – this was important as Exfinco's offer only extended to goods which complied with these warranties). The Court of Appeal reversed that decision through the use of the maxim *certum est quod certum reddi potest* – that is certain which can be rendered certain. We have come across the doctrine in cases such as *Sudbrook Trading Estate Ltd v Eggleton*,²⁴ where subsequent events can help clarify the terms of a contract.

11 That aside, however, the Court of Appeal emphasised that the case did not involve the question of a sham, and was simply a question of legal characterisation.²⁵ This was somewhat unusual as, unlike *Cheah*

22 *Supra* n 18, at 185.

23 [1991] BCLC 936.

24 [1983] 1 AC 444 at 479 *per* Lord Diplock.

25 *Supra* n 18, at 159–160 *per* Dillon LJ.

where the dispute involved the contracting parties, *Exfinco* involved a priority dispute between Exfinco and another creditor (who was also a shareholder of Parrot), the Welsh Development Agency (“WDA”) that was formed to promote industrial activity in Wales, which had a charge over Parrot’s book debts to secure a counter-indemnity owed by Parrot to the WDA for a guarantee that the WDA had to pay on to other financiers that had extended funding to Parrot under a revolving credit facility. It was clearly a case where external interests were involved, but the pleadings restricted the court to an examination of the documentation. But, because of the third party effects, some policy discussion was unavoidable, with Dillon LJ stating that he thought there was “nothing illegal”²⁶ about Exfinco’s choice of financing the transaction through a sale and repurchase agreement rather than a loan secured on a charge that required registration under the UK Companies Act.²⁷

12 What is interesting, though, is Staughton LJ’s detailed examination of the internal and external routes to construction, or to use parallel terminology from trust law, formal and substantive shams.²⁸ In trust law, formal shams are those where it is clear from the trust deed that the settlor intended to retain full control of trust assets.²⁹ But where a trust deed looks correct and consistent on its face, the subsequent conduct of parties may be used as evidence to prove a substantive sham because of the settlor’s *de facto* control of the trust.³⁰ The sham doctrine in trusts, is however, very narrow. A trust will only be a sham if both the settlor and trustee intend it not to be effective but for a third party or court to think that it is. So, a settlor who parts with beneficial ownership but retains some influence over the trustee’s administrative decisions usually creates a valid trust.³¹ It may be, however, that the transfer is

26 *Supra* n 18, at 168.

27 Section 396(1)(c) of the Companies Act 1985 (c 6) (UK).

28 *Supra* n 18.

29 *Rahman v Chase Bank Trust Company (CI) Ltd* [1991] Jersey LR 103. In Singapore, s 90(5) of the Trustees Act (Cap 337, 2005 Rev Ed), which was introduced by the Trustees (Amendment) Act 2004 (No 45 of 2004), preserves the validity of a trust which allows a settlor to retain investment and asset management functions, but it is debatable how much more the common law permits.

30 *Midland Bank plc v Wyatt* [1995] 1 FLR 696 (CA) (also on defrauding creditors, but note the modern day UK legislation discussed at *infra* nn 31 and 32). A part rather than all of the trust can be a sham: *Hitch v Stone* [2001] EWCA Civ 63 at [85], where Arden LJ also stated that where sham is pleaded, the court may examine the subsequent conduct of the parties and is not restricted to an examination of the four corners of the trust document (at [65]).

31 *Hill v Spread Trustee Co Ltd* [2005] EWHC 336. The transaction, however, fell foul of s 423 of the Insolvency Act 1986 (c 45) (UK) which is a more modern version of the

caught by s 73B of the Conveyancing and Law of Property Act as being a conveyance made with intent to defraud creditors.³² This alternative cause of action may explain the narrowness of the sham doctrine with trusts.³³

13 In its purest form, the internal route is about categorisation based on a construction of the documentation. The external route was said by Staughton LJ to involve either a sham, “or there may be proof of a subsequent variation, as was argued in *Lloyd’s & Scottish Finance Ltd v Cyril Lord Carpets Sales Ltd* [1992] BCLC 609”.³⁴ Variation is discussed in some detail by both Berg and Atherton & Mokal,³⁵ and could be seen, alongside estoppel and waiver, as belonging in a different category in that it is even more “external” than sham or pretence. While Fidelis Oditah³⁶ believed that these were in fact the only situations in which the courts can look at post-contractual conduct, they have their own conceptual difficulties and it is likely that they do not alter the initial characteristics of, say, a fixed or floating charge which tests their priority against

now-repealed s 172 of the Law of Property Act 1925 (c 20) (UK), on which our s 73B of the Conveyancing and Law of Property Act (Cap 61, 1994 Rev Ed) is based.

32 Cap 61, 1994 Rev Ed, which was recently applied in *Wong Ser Wan v Ng Bok Eng Holdings Pte Ltd* [2004] 4 SLR 365 where Prakash J held that the good faith defence required the transferee to have more than just a belief that all the steps have been regularly and properly carried out. The transferee must have had no reason to believe that there was anything untoward about the transaction.

33 Policy considerations have also been used to explain the cases of *Spectrum*, *supra* n 1, and *Buchler v Talbot* [2004] 2 AC 298 (“*In re Leyland Daf Ltd*”) – the latter provides that liquidation expenses do not have priority over the claims of a floating chargeholder, which is unlike the position in Singapore as set out in s 328(5) of the Companies Act (Cap 50, 1990 Rev Ed) (“the Companies Act”), which was amended by the Companies (Amendment) Act 1993 (Act 22 of 1993) (“the Companies (Amendment) Act 1993”) to give priority over floating charges to all costs, charges and expenses of winding up including remuneration of the liquidator, alongside other preferential debts that had previously been conferred that priority. This is discussed further *infra* at n 61. Gerard McCormack, “Lords Hoffmann and Millett and the shaping of Credit and Security Law” [2005] LMCLQ 491 at 497 argues that the *In re Leyland Daf Ltd* decision is a “consolation prize for the secured creditor ... denied the opportunity of creating effective fixed security over most circulating assets in *Brumark* ...” See also Liz Wild, “*Spectrum* and *Leyland Daf* – The Spectre of New Claims” (2006) 27 *Company Lawyer* 151. The new Companies Act 2006 (c 46) contains a cl 1282 which reverses the effect of *In re Leyland Daf Ltd*. There has been some criticism of this by the Financial Law Committee of the City of London Law Society: see Geoffrey Yeowart [2006] *Butterworths J Int’l Bank & Fin L* 101. I thank Asst Prof Wee Meng Seng of the Faculty of Law, NUS, for the discussion in this footnote.

34 *Supra* n 18, at 186.

35 *Supra* n 4.

36 Fidelis Oditah, *Legal Aspects of Receivables Financing* (Sweet & Maxwell, 1991) at pp 101–102.

preferential creditors by looking at whether “as created” they were such.³⁷ These are, perhaps, cases that come closest to true recharacterisation as opposed to a characterisation that takes effect retrospectively because of sham or pretence.³⁸

14 Where more usual categorisation at (or back to) the point of creation is concerned, the distinction between on the one hand documentary consistency, and sham or pretence on the other is seen also in the cases on the lease/licence divide. On the one hand, documentary consistency is paramount – as Lord Templeman said in *Street v Mountford*: “My Lords, the only intention which is relevant is the intention demonstrated by the agreement to grant exclusive possession for a term at a rent.”³⁹ In *AG Securities v Vaughan*,⁴⁰ however, there were two appeals that were allowed by the House of Lords. In the first, the House allowed the appeal on the basis that it required “the highest degree of artificiality”⁴¹ for the agreement, on its face, to grant exclusive possession to four different occupants. In the latter, however, what was termed a licence in the agreement was seen as a “pretence” to avoid the Rent Acts, in a case where exclusive occupancy was in fact granted to a couple who lived as man and wife, as the owner never exercised his right to use the flat together with the purported licensees.

15 Berg, however, believes that Lord Walker of Gestingthorpe in *Spectrum* rejected a dual approach towards the classification of fixed or floating charges.⁴² He refers to his Lordship’s speech:⁴³

It is also necessary to bear in mind Lord Millett’s warning in *Agnew* [2001] 2 AC 710, 730, para 48, that formal provision for a blocked account is not enough “if it is not operated as one in fact.” Lord Millett did not expand on this point, which may raise difficult questions as to what Staughton LJ, in *Welsh Development Agency v Export Finance Co*

37 See Berg, *supra* n 4, at 42. This is clearly the position in Singapore: see s 328(5) of the Companies Act, as amended by the Companies (Amendment) Act 1993; and *Dresdner Bank AG v Ho Mun-Tuke Don* [1993] 1 SLR 114, which is discussed at para 21 of the main text below.

38 Sham and pretence are treated similarly here. While Atherton & Mokal, *supra* n 4, at 16, distinguish between them on the basis that the former is dependent on a common intention and the latter a unilateral intention, Berg, *supra* n 4, at 40, does not.

39 *Supra* n 7, at 826.

40 [1990] 1 AC 417, noted in P V Baker, “Shams or Schemes of Avoidance” (1989) 105 LQR 165.

41 *Id.*, at 454 *per* Lord Bridge.

42 *Supra* n 4, at 47.

43 *Supra* n 1, at [160].

Ltd [1992] BCLC 148, 186-7, referred to as “external” and “internal” routes to the construction of commercial documents. This point is discussed in an article by Stephen Atherton and Rizwaan Jameel Mokal in (2005) 26 *Company Lawyer* 10, 16-18.

16 But this suggests either a largely internal approach, with post-contractual evidence (if relevant at all) only used as a means of confirming the intentions of the parties, as Choo J did in *Cheah*, an *inter partes* case; or a purely external approach, where post-contractual acts are always examined, in the light of policy considerations and external interests, in determining how a transaction should be characterised. The two are seemingly different. It may be that Lord Walker had in mind the latter as he stated earlier in the *Spectrum* decision:⁴⁴

On the lease/licence issue, the public interest is the protection of vulnerable people seeking living accommodation. On the fixed/floating issue, it is ensuring that preferential creditors obtain the measure of protection which Parliament intended them to have. This public interest is unaffected by the changes in the classes of preferential creditors made by section 251 of the Enterprise Act 2002.

17 Berg argues that “even when faced with a ‘pure’ question of interpretation, a court has to consider the factual background”.⁴⁵ He points out that the authority of *Exfinco* has been weakened today as we cannot ever avoid looking at the facts surrounding the transaction, at least with a clause of the *Siebe Gorman*⁴⁶ type which is silent on the

44 *Id.*, at [141]. See also [140] of the decision.

45 *Supra* n 4, at 47. Berg, however, admits that Lord Millett’s *dicta* in *Agnew v Commissioner of Inland Revenue* [2001] 2 AC 710 (PC on appeal from New Zealand) (“*Agnew*”) which Lord Walker referred to in *Spectrum* at [140] and [160], about the need for a blocked account to be operated as such was not a necessary requirement in all cases: *supra* n 4, at 41. It remains a question of fact whether sufficient control was maintained, which is the argument advanced in this article. This is why it is difficult to accept Berg’s assertion that in *Re Keenan Bros Ltd* [1986] BCLC 242 (SC, Ireland) was incorrectly approved by the Lord Walker in *Spectrum* (at [140]). Berg, *supra* n 4, at 45–46, points out that in *Re Keenan Bros Ltd*, where the Revenue Commissioners as preferential creditors made submissions that the charge in question was a floater, the blocked account was actually only properly operated one month before the dispute arose and not for four months from creation of the charge. There was no actual control for many months after the charge was created. Berg believes that the approach of the Irish Supreme Court at that time of not examining subsequent events could also be seen in *Re Wogan’s (Drogheda) Ltd* [1993] IR 157, and that it is quite different today after *Spectrum*. But while it is true that courts are now more willing to scrutinise post-contractual events, whether a transaction is a sham or pretence is still a question of fact. It might have been enough to have had control at the relevant time, if the totality of the evidence was not sufficiently unequivocal to disrupt the documentation.

46 *Siebe Gorman & Co Ltd v Barclays Bank Ltd* [1979] 2 Lloyd’s Rep 142.

amount of control over book debts/proceeds that a purported fixed chargee is supposed to have. This is supported by what Lord Scott of Foscote said in *Spectrum*⁴⁷ about examining the parties' later operations to infer that the account was in fact intended to be blocked, even if the documentation left this open. However, this use of post-contractual events is closer to the maxim *certum est quod certum reddi potest*, which we saw was used to solve the uncertainty over whether Parrot acted as principal or agent in the *Exfinco* case.⁴⁸ It is simply a mechanism to ascertain the terms of the agreement. Indeed, the actual *ratio* of *Spectrum* could be a narrow one, concerned only with the construction to be given to a clause which confers discretion on the debtor as to the type of account into which the proceeds of a book debt has to be paid, and how that account was to be operated. The House of Lords thought that because the debtor retained discretion on this matter, and could therefore use the proceeds in the ordinary course of business, that this was an indicium of a floating charge. So, reference to post-contractual actions in the case of a stipulated blocked account that is not operated as such were *obiter*. If so, we are really talking about a modified, though, still "internal" approach.⁴⁹

18 It is when the labels are unequivocally clear, and yet the surrounding circumstances indicate something else that we see most clearly that courts almost always use an "external" route to characterisation, and policy concerns are always there, even if sometimes not fully explicated. In Lord Walker's example above,⁵⁰ a licence or fixed charge that is labelled as such would be scrutinised quite carefully in the light of pre- and post-contractual behaviour to see if it has offended any legislation or other consideration which, as Lord Walker says, in those instances are to protect the vulnerable non-owner occupier of property or the preferential creditors. On the other hand, where the document in fact provides that a lease or floating charge is, respectively, created, in

47 *Supra* n 1, at [119].

48 See para 10 of the main text above.

49 *Agnew, supra* n 45, which the House of Lords in *Spectrum* relied on, is even more "internal" in that sense, as there a *Re New Bullas* type clause was at issue (see *Re New Bullas Trading Ltd* [1994] 1 BCLC 485 (CA)), and that expressly created a floating charge over the proceeds of the book debts, over which there was a purported fixed charge. On the face of it, because it permitted the use of the proceeds, and proceeds could not be separated from the uncollected book debts, there was no fixed charge over the book debts from inception either. To the same effect is the recent decision of *Ashborder BV v Green Gas Power Ltd* [2005] 1 BCLC 623 where clauses in the loan documentation (when given their natural meaning) expressly permitted disposal of the collateral in the ordinary course of business.

50 See para 16 of the main text above.

situations where the same protective considerations are present, that would appear to be almost conclusive of its effect – the intention to abide by the law is taken at face value. But the “internal” route has been taken only because there is nothing offensive about it externally. True it is that sometimes sham or pretence is not pleaded, but as Dillon LJ showed us in *Exfinco*,⁵¹ and as we shall see in our own equivalent case used as justifying the primacy of documentation, *Thai Chee Ken v Banque Paribas*,⁵² judges will still ask the policy question, and examine the factual matrix (though perhaps not in as much detail as in cases where a sham is actually pleaded), before confirming the documentary intention. Put differently, policy considerations dictate how closely we look at the parties’ actions. And, consistent with this argument, in a two-party case such as *Cheah*, the parties’ post-contractual actions are not strictly relevant (even though Choo J looked at them to corroborate his findings of the parties’ intentions at the time of contracting) because there are no external considerations. But we know that only because we have looked and found that the agreement made by the parties has no impact on third parties.

19 Perhaps Professor Steven Schwarcz put it best in the context of when he believed courts in the US recharacterise or ought to recharacterise their transactions, which is when it:

- (a) thwarts or significantly impairs legislative policies; or
- (b) has material improprieties and causes either manifest net harm or intentional externalities.⁵³

But the internal and external divide is still helpful in guiding our analysis, since if external factors are not at issue, then it is largely the documentation that would govern, though perhaps not in the pure form envisaged by Staughton LJ in *Exfinco*. External factors may not be an issue either because the parties have, even taken at face value, acted consistently with legislative policy or if sham or pretence is not pleaded. But we have seen that even in these situations, and even in two-party cases, courts may still refer to post-contractual evidence to see if there is enough evidence corroborating their findings on the documentation. But where external factors are directly relevant, a greater balancing exercise is taken by the court, involving both a close scrutiny of the parties’ conduct, as well as

51 See para 11 of the main text above.

52 *Supra* n 13.

53 Steven L Schwarcz, “Collapsing Corporate Structures: Resolving the Tension between Form and Substance” (2004) 60 *Business Lawyer* 109.

how severely the relevant policy considerations or third parties have been affected by the transaction. We shall see that this has indeed been the case in Singapore.

IV. Singapore cases⁵⁴

20 The decision of the House of Lords in *Spectrum* should not come as a surprise to practitioners in Singapore, given the number of decisions we have had in the past involving letters of hypothecation used in share financing schemes in the Pan El crisis and subsequent stockbroking collapse in the mid-1980s. In every case,⁵⁵ all excellently reasoned, the banks failed to persuade the court that they had a fixed rather than floating security over uncollected share certificates left in the custody of stockbroking firms.⁵⁶ These firms were entitled to restricted use of the certificates in the course of their business. It was held that labels were irrelevant and enforcement paramount. Due largely to the subsequent conduct of the parties, what may have appeared to be fixed charges were characterised as floating charges.

21 It did not matter that daily certificates were issued to the bankers at the end of each working day tracing the movement of the share certificates. The problem remained that, notwithstanding the terms of the agreement, the stockbroking firm retained the freedom to deal in those shares. Consequently, when delivery up was ordered by a court, that was seen as crystallisation of the floating charge, which was created and hence registrable as such, and not evidence that the charge was fixed from inception.⁵⁷ Neither was it enough that the memorandum of deposit specified that the shares be kept in individual safes at the stockbroking firms, labelled in the bank's name, or that share certificates removed in the course of the trading day had to be replaced by other share certificates of equivalent value, with any shortfall repaired by a monetary deposit into the company's bank account. The arrangement created insufficient

54 On taking security in Singapore generally, see Joyce Lee, "Company Charges in Singapore: Legal and Practical Implications" (2003) 14 Int'l Company & Comm Rev 1; Hans Tjio, "Personal Property Security Interests in Singapore and Malaysia" (1995) 16 *Company Lawyer* 28.

55 The first of these cases was *Re Lin Securities (Pte)* [1988] SLR 340 (HC).

56 Section 130N of the Companies Act, which was introduced by the Companies (Amendment) Act 1993 (No 22 of 1993), has created a scripless regime for all securities traded on the Singapore Exchange. There is a prescribed statutory form for certain forms of security over scripless shares.

57 See *Re City Securities* [1990] SLR 468 (HC), affirmed in *Dresdner Bank AG v Ho Mun-Tuke Don* (CA), *supra* n 37.

creditor control as the borrower could remove the share certificates without consulting the bank. It was common ground, however, that there would have been a fixed charge if shares were in fact held by the bank.⁵⁸

22 The crucial issue in these Singapore cases surrounded charge registration. As s 131 of the Companies Act⁵⁹ is worded, fixed charges over shares do not have to be registered, whereas all floating charges have to be. Consequently, if they had been fixed charges, the banks would not have ended up as unsecured creditors for failing to register their security interests. While it is arguable from *Exfinco* and the next case we will examine that issues of registration *per se* do not involve similar state-interest analysis, the policy considerations in our local fixed/floating charge cases are not dissimilar to those in *Spectrum* in that the liquidator would eventually have had to address submissions from certain preferential creditors had it been inclined to accept that they were fixed charges. In this vein, it has been highlighted that the position under s 328 of the Companies Act is somewhat, though not exactly, similar to that which was operative in England in *Spectrum* which, being post the Enterprise Act 2002,⁶⁰ no longer included as preferential debts the debts due to the Inland Revenue and Customs and Excise.⁶¹

23 In *Thai Chee Ken v Banque Paribas*,⁶² however, the issue was whether what had been created was even a charge at all. The liquidators of Pan El argued that a sale and repurchase agreement for shares made with the bank was void as an unregistered charge under s 131 of the Companies Act. As in *Cheah's* case, the purported seller of the shares, Pan El, bore all legal and stamp fees incurred in the sale. Further, Pan El provided security for its repurchase obligation by assigning certain real properties and proceeds of sale to Banque Paribas (which in fact recorded the transaction on its books as a loan until Pan El failed to repurchase the shares as its rights issue to fund the buyback was not approved by the

58 *Re EG Tan & Co (Pte)* [1990] SLR 1030 (HC), affirmed in *Chase Manhattan Bank NA v Wong Tui Sun* [1993] 1 SLR 1 (CA).

59 Cap 50, 2006 Rev Ed.

60 2002 c 40 (UK).

61 See Dora Neo, *supra* n 2, at 646 who points out that the difference is that items like taxes have been removed from the list of preferential debts in the UK, whereas in Singapore it has been and is still the case that these are preferential debts which have priority over unsecured creditors but not floating chargeholders because of the way that s 328(5) of the Companies Act is drafted. Although s 328(5) was amended by the Companies (Amendment) Act 1993, it was only to provide that the expenses of winding up, and not taxes, have priority over the floating charge. See further *supra* at n 33.

62 *Supra* n 12.

then Stock Exchange of Singapore). But unlike *Cheah's* case, this was not a two-party case. Arguably, therefore, the transaction should have been subjected to even greater scrutiny than in *Cheah's* case, where it should be recalled that Choo J looked at post-contractual evidence to confirm the parties' intention at the time of contracting.

24 It was held, however, by Yong Pung How CJ (delivering the judgment of the Court of Appeal), that there was no suggestion that the transaction was a sham or that the bank had been fraudulent, and consequently:⁶³

[f]reedom of contract should be respected to the extent that it must be recognised that different legal forms can be used to achieve the same economic object or end, and that some legal forms legitimately fall outside the statutory provisions. In the latter situation, it is not correct to speak of evasion of the law but rather there has to be recognition of the fact that lacunae exist in the statute which the legislature, and the legislature alone, has to decide whether to close. It is thus possible for some financing transaction to fall outside the statutory provisions and the fact that a transaction is a financing arrangement does not *ipso facto* bring it within the legislation since the object of a transaction is distinct from its nature at law.

25 This was Singapore's *Exfinco* (which did not in fact refer to the slightly earlier English Court of Appeal decision although the latter was later applied in *Nissho Iwai International (Singapore) Pte Ltd v Kohinoor Impex Pte Ltd*⁶⁴) with its focus on the documentation, but without the equivalent of Staughton LJ's discussion of the "internal" and "external" approaches to characterisation.⁶⁵ It is submitted, however, that because Yong CJ looked at the intensity of the policy considerations,⁶⁶ as well as the surrounding circumstances in which the document came into being, he did not apply a purely "internal" approach to characterisation. In this he was closer to Dillon LJ in *Exfinco*,⁶⁷ and to the arguments that have been made in the previous part of this article. As there was nothing offensive to legislative policy from having a transaction characterised as a

63 *Id.*, at [13]. See also Lord Devlin in *Chou Yoong Hong v Choong Fah Rubber Manufactory Ltd* [1962] AC 209 at 216–217: "If in form it is not a loan, it is not to the point to say that its object was to raise money for one of them or that the parties could have produced the same result more conveniently by borrowing and lending money." *Cf Re Curtain Dream plc* [1990] BCLC 925 (sale and repurchase held to be a disguised loan).

64 [1995] 3 SLR 268.

65 *Supra* n 12, at [12]. See paras 7 and 12 of the main text above.

66 *Id.*, at [13].

67 See para 11 of the main text above.

sale and repurchase, Yong CJ only looked for enough surrounding evidence to support that characterisation,⁶⁸ and not other evidence that may have contradicted that finding, such as the fact that the bank had recorded the transaction internally as a loan.⁶⁹

26 As a matter of policy, we know from retention of title clauses (“*Romalpa* clauses”),⁷⁰ that it is possible to have unregistrable structures that mimic the effect of a loan secured by a charge. But with *Romalpa* clauses, we have seen that it is a risk-taking exercise in that it becomes a registrable charge where the drafting is too ambitious given the reality of how the relevant goods to which title is sought to be retained will be used.⁷¹ So it is with whether a transaction is characterised as a true sale or a loan, or if we prefer, the “recharacterisation risk” as described by the English Law Commission.⁷² While *Thai Chee Ken*’s case comes close to the line given the way the parties themselves seemed to treat it as a loan, what appeared to sway the court was that the bank was in fact willing to provide a loan, but it structured the deal differently because it was Pan El that said that it could not breach a negative pledge clause that had been given in a prior lending transaction. Under Schwarcz’s framework laid out in the previous part of this article, the possible affected parties are these other private creditors. But it is hard to argue that they had or have suffered “manifest net harm or intentional externalities”⁷³ since no new money would have been forthcoming from Banque Paribas had it not been assured of some protection in light of the negative pledge clause.

27 A case that did cross the line, albeit in what could be seen as in the opposite direction, was *Pinetree Resort Pte Ltd v Comptroller of Income Tax*.⁷⁴ Here, a country club tried to raise funds through selling new memberships. Fifteen per cent of the sum payable on obtaining membership was attributed to a membership or entrance fee. An “initiation deposit” that was repayable in 30 years made up the remaining 85% of the sum payable on joining the club. Pinetree tried to argue that the latter was an interest-free loan from the members, which was how they had accounted for the moneys on their books. The court, however, thought that the initiation deposit was not a loan but a sale and

68 *Supra* n 12, at [15]–[29].

69 *Id.*, at [30]–[31].

70 *Aluminium Industrie Vaassen BV v Romalpa Aluminium Ltd* [1976] 1 WLR 676 (CA).

71 See, eg, *Clough Mill Ltd v Martin* [1985] 1 WLR 111 (CA).

72 *Supra* n 20, at para 6.34.

73 Schwarcz, *supra* n 53, and para 19 of the main text above.

74 [2000] 4 SLR 1, where Yong CJ again delivered the judgment of the Court of Appeal.

contractual buyback of the club membership. It found for the Comptroller of Income Tax, and held that income tax was payable on the entire sum that was raised from the sale of memberships, noting that two other clubs, Laguna Golf and Country Club and Raffles Marina Club, had true loan agreements that were structured with a trust deed and trustee corporation, and which stated clearly that they were borrowing from the members.⁷⁵

28 It is not easy reconciling these decisions, but if we look back at Schwarcz's factors enumerated above and the arguments made on when and why transactions are recharacterised, we can see the importance attached to legislative policy. Where tax, and in particular income tax, is concerned, courts will pass any tax avoidance measures (so called) through a fine-toothed comb to see if they in fact evade tax policy and ought to be recharacterised. Lord Walker has stated extra-judicially that this should be contrasted with, say, estate duty, where the state's interest in strict enforcement is less apparent.⁷⁶ So in *Pinetree*, it may well have been, from some perspectives, a loan between the club and members, but from the perspective of the Inland Revenue Authority of Singapore, it was a sale of memberships giving rise to taxable income. It reinforces the arguments that have been made that labels should matter much less and that "[w]hat we have to do is to work out the qualifying conditions for foreseeable corresponding consequences to arise".⁷⁷

75 *Id.*, at [12] and [28].

76 Robert Walker, "Ramsay 25 Years on: Some Reflections on Tax Avoidance" (2004) 120 LQR 412 at 419, referring to estate duty as "an abstract and cerebral tax [that] does not raise strong intuitive feelings as to how Parliament must have intended it to operate, or as to the scandal of avoiding it by artificial means". Compare s 33 of the Income Tax Act (Cap 134, 2004 Rev Ed) ("the Income Tax Act"), which gives the Inland Revenue Authority of Singapore a wide discretion to disregard or vary a transaction or disposition which purpose is to directly or indirectly alter the incidence of tax, or to relieve, reduce or avoid any liability under the Income Tax Act.

77 See Hans Tjio, "Rethinking the Personal and Proprietary Distinction" [1993] Sing JLS 198 at n 70, referring to Alf Ross, "Tù-tù" (1957) 70 Harv L Rev 812; and Felix Cohen, "Transcendental Nonsense and the Functional Approach" (1935) 35 Colum L Rev 809. In this vein, in the Court of Appeal in *Spectrum* ([2004] Ch 337 at [52] and [53]), Lord Phillips of Worth Matravers MR noted the uncomfortable fit certain forms of security, such as a floating charge with a negative pledge clause, have with the traditional notion of a fixed or floating charge, and thought that one solution would be to adopt the functional approach of "structural personal property security legislation" found in other countries (at [99]). See now the Report of the English Law Commission (Law Com No 296) entitled *Company Securities Interests* (August 2005) at para 1.14, recommending substantial changes but not a radical overhaul of the system.

V. Conclusion

29 Choo J's willingness in *Cheah* to look at post-contractual events even in a two-party case, with little external interest in the matter, attests to the greater risk today that a transaction affecting third parties will be characterised in a way that the contracting parties had expressly tried to avoid. It would appear, therefore, that lawyers giving "true sale" opinions to structures that have a borrowing or lending effect must now quite often qualify those opinions or at least word them more conservatively.⁷⁸ It is an exercise that carries what the English Law Commission terms a "recharacterisation risk".⁷⁹ We have also seen that whether a transaction is labelled a sham or pretence is a question of fact, unlike the interpretation of a contractual clause, which is a question of law.⁸⁰ What this means in practice is that the findings by the lower or trial courts should only ever exceptionally be disturbed by a higher appellate court. That this is indeed the case can be seen in *Cheah* itself where the Court of Appeal dismissed the appeal without a written judgment.⁸¹

30 This last point was emphasised by the Ontario Court of Appeal in *Metropolitan Toronto Police Widows and Orphans Fund v Telus Communications Inc.*⁸² Here a company had used securitisation proceeds to redeem bonds that it had previously issued which contained a covenant stating that the bonds were not to be redeemed "through direct or indirect borrowings having an interest cost to the Company of less than 11.35 per cent per annum". The company itself did not borrow but sold its accounts receivables to a special-purpose vehicle which then issued commercial paper on the capital markets to raise fresh funds. As in the case of all legitimate securitisation structures,⁸³ this was done to effectively reduce financing costs for the company. Because of the better credit rating of the special-purpose vehicle, it was itself able to obtain financing that made the entire securitisation cost less than the 11.35% per annum that the company had been paying on its own tranche of bonds. This was challenged as a breach of the loan covenant given by the

78 Berg points out that the relevance of recharacterisation today even where only documentary evidence seems to be at issue means that "some downward adjustment is appropriate to the credit rating" of *Exfinco*: *supra* n 4, at 47.

79 *Supra* n 20, at para 6.34.

80 Berg, *supra* n 4, at 40–41.

81 *Supra* n 5.

82 75 OR (3d) 784; 2005 Ont Rep LEXIS 115. Leave to appeal to the Supreme Court of Canada was refused. I thank Chou Sean Yu of WongPartnership for bringing this case to my attention.

83 See Steven L Schwarcz, "Enron and the Use and Abuse of Special Purpose Entities in Corporate Structures" (2002) 70 U Cincinnati L Rev 1309 at 1314–1318.

company. The main argument, which succeeded on appeal, was that the special-purpose vehicle had borrowed from the financial markets, so the bonds had been redeemed by the company through “indirect borrowings”.

31 However, the Court of Appeal stressed that whether the initial sale itself to the special-purpose vehicle was a true sale or collateralised loan was a question of mixed fact and law, and because it inclined more towards fact than law, that deference had to be given to lower courts or trial judges,⁸⁴ which in this case had held that the initial sale was a true sale of receivables, and consequently that the company had not directly borrowed to replace its tranche of bonds.⁸⁵ It therefore agreed with the lower court’s decision that, as there were no sham or public policy concerns, the characterisation of the sale of receivables itself as a true sale was correct as there was no right of redemption of the receivables.⁸⁶ The court emphasised, however, that this was unlike the main argument which succeeded in the Court of Appeal regarding indirect borrowings, which was more a question of law.

32 While practicing lawyers may complain of the uncertainty that the factual approach may cause to commerce, they must be careful what they wish for.⁸⁷ They should be mindful that legal certainty can just as much be created by consistently characterising these transactions as loans given that it will have some of the latter’s economic characteristics. Put differently, there is just as much commercial certainty in always upholding the parties’ expressed intentions as there is in ignoring them. In this vein, Berg has separately written that the attitude of the courts had already been changed by Enron’s abuse of forward contracts of oil and gas to banks like JP Morgan Chase which were really loans by the latter that were used to inflate the financial statements of the former.⁸⁸ If pushed, as the London financial community appeared to try to do in *Spectrum*, courts today may well give precedence to economic function rather than

84 *Supra* n 82, at [34].

85 [2003] OJ No 128, 30 BLR (3d) 288 (SCJ), where Ground J dismissed the action by the company’s bondholders on both grounds, *ie*, the direct and indirect application of the borrowed funds.

86 *Supra* n 82, at [42].

87 At first instance in *Exfinco*, *supra* n 23, at 947, it was said by Sir Browne-Wilkinson VC that “those who live by the sword may also die by the sword”, meaning that one has to live with the legal consequences of a purely literal construction, and cannot have some parts of an agreement subject to a different method of interpretation.

88 Alan Berg, “Recharacterisation after Enron” [2003] JBL 205 at 208–209.

the parties' intentions whether expressed in the documentation (as that community preferred) or as reflected in their pre- and post-contractual actions (which seems to be the position set out by the House of Lords in *Spectrum*).

33 Indeed, in 2002, the English Law Commission recommended that even a true sale of receivables under a factoring or block discounting or securitisation arrangement should be registrable unless it forms part of a larger transaction where, for example, the buyer is purchasing the entire business as a whole.⁸⁹ After public feedback, the Law Commission confirmed these recommendations in 2005,⁹⁰ although it appears that wider reforms accepting the primacy of the economic functionality of security generally (and not just in the case of receivables) will not presently be made to the personal property security regime in the UK.⁹¹

34 The arguments for legal certainty may not therefore turn out in a way favoured by a large number of commercial lawyers and their clients. With public opinion and policy turning against transactions involving financial engineering and little else, asking for greater certainty may well see many sale and repurchase agreements being characterised as loans secured by floating charges, and not even fixed securities, where the purported buyer has insufficient control over the underlying collateral.

89 *Supra* n 20, at para 7.45.

90 *Supra* n 77, at paras 1.36, 4.18 and 4.28.

91 *Id.*, at para 1.14. See further Gerard McCormack, "Reforming the Law of Security Interests: National and International Perspectives" [2003] Sing JLS 1.