

# ANALYSIS

## PRE-CONTRACTUAL STATEMENTS: MISREPRESENTATIONS OR COLLATERAL CONTRACTS?



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*Banks have hardly been given due recognition for their contribution to the common law system. Many important cases emanate from banks anxious but determined to recoup at least part of the money they have lent. In the current economic downturn, there is no shortage of such cases. A recent addition is the Court of Final Appeal's decision in Bank of China (Hong Kong) Ltd v Fung Chin Kan and Lee Yuen Wah.<sup>1</sup> In many respects, this case is simply one of the many mortgagee actions heard by the Hong Kong courts. Two features, however, make the BOC case special: first, the Court of Final Appeal's rather radical approach towards collateral contracts, and secondly, the brevity with which the Court of Final Appeal disposed of the undue influence argument put forward by one of the defendants, Mrs Fung. This article examines the first of these two points.*

### The Case

#### *The Facts*

In May 1997, Mr and Mrs Fung charged their property to The China State Bank, Limited (which was subsequently merged into Bank of China (Hong Kong) Limited (BOC) by virtue of the Bank of China (Hong Kong) Limited (Merger) Ordinance)<sup>2</sup> as security for the indebtedness of a company called System Management Consultancy Ltd (SMC). The Fungs had no particular affiliations with SMC, except that Mr Fung had been involved in business dealings with SMC and its directors and shareholders since 1996.

The legal charge executed by the Fungs in favour of BOC was in a form commonly used in Hong Kong. It was prepared on BOC's behalf by Mr Hank Lo, a solicitor who, in Mr Justice Litton NPJ's words, "figures prominently in this case". As BOC's solicitor, Mr Lo drafted the legal charge on BOC's behalf and supervised its due execution by the Fungs. However, Mr Lo's role in this saga is in no way limited to these actions. In April 1997, a meeting

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<sup>1</sup> [2003] 1 HKLRD 181 (the BOC case).

<sup>2</sup> Cap 1167.

was held in Mr Lo's office, attended by Mr Fung, Mr Simon Ngan (who was the husband of a director of SMC) and a Mr Paul Lau. Litton NPJ described Mr Ngan and Mr Lau as "the persons behind SMC", so presumably they were the "brain" of SMC. At this meeting, the three gentlemen discussed an arrangement to refinance certain banking facilities granted by Wing Hang Bank to SMC with new banking facilities from BOC. As part of this arrangement, the Fungs' flat (which was then mortgaged to Wing Hang Bank to secure a HK\$4 million loan to SMC) would be redeemed and mortgaged in favour of BOC. On the evidence, the Court of Final Appeal found that at the meeting it was agreed among the three gentlemen that the Fungs' liability to BOC would be limited to HK\$3.3 million.

It was also agreed at the meeting that certain documents were to be drawn up by Mr Lo to give effect to the arrangement. Among these documents would be undertakings by SMC, Mr Ngan and Mr Lau respectively to indemnify the Fungs for losses they might incur as a result of executing the legal charge. It is not apparent on whose behalf Mr Lo was acting in respect of that meeting and the documents to be drafted. What is clear, however, is that Mr Lo had not at that stage received BOC's instructions to prepare a mortgage over the Fungs' flat, so Mr Lo could not have been acting as BOC's lawyer at that meeting.

On 9 April 1997, the day after the meeting, a number of draft documents were faxed by Mr Lo to Mr Fung. Amongst them was a draft undertaking by SMC to indemnify the Fungs, which read as follows:

"In consideration of your execution of an all monies legal charge in favour of The China State Bank, Limited in respect of General Banking Facilities (for the time being agreed at HK\$3,500,000) granted to our company, we hereby undertake that we shall be responsible for ... the repayment of the said general banking facilities and the discharge of the said legal charge on or before 30 September 1997."

The error in this draft undertaking was noticed by Mr Fung. He called Mr Lo to point out that the figure should be "HK\$3,300,000", not "HK\$3,500,000". To the Court of Final Appeal, this piece of evidence was indicative of an agreement that the Fungs' liability would be limited to HK\$3.3 million.

On 10 April 1997, BOC gave instructions to Mr Lo's firm to prepare the legal charge as security for SMC's indebtedness to the bank. BOC's instructions were to prepare a legal charge to secure "[a]ll monies in respect of General Banking Facilities (including facilities granted against trust receipts) (*for the time being agreed at HK\$3,300,000*) together with interest ..."<sup>3</sup> As BOC's

<sup>3</sup> See para 31 of the BOC case (n 1 above). Emphasis added.

solicitor, Mr Lo proceeded to prepare the legal charge and arrange for its execution by the Fungs. The legal charge prepared by Mr Lo was expressed to secure all present and future indebtedness of SMC to BOC, as well as all other liabilities of SMC to BOC. It contained no limit whatsoever on the Fungs' liability. The figure "HK\$3,300,000" did not appear anywhere in the document. On 14 May 1997, the Fungs executed the legal charge at Mr Lo's office.

SMC soon defaulted in its payments to BOC. The total indebtedness outstanding amounted to some HK\$16,200,000, which far exceeded the then market value of the property charged to BOC by the Fungs. BOC commenced an action against the Fungs on the legal charge under Order 88 of the Rules of the High Court, asking for possession of the charged property (in contemplation of exercising its power of sale) as well as payment by the Fungs of the total amount owing by SMC to BOC pursuant to their personal covenant to repay contained in the legal charge.

#### *The Court of Final Appeal Decision*

Litton NPJ delivered the leading judgment of the Court of Final Appeal in the BOC case. His Lordship ruled that there was a collateral contract between BOC and the Fungs, which existed alongside but independent of the main contract constituted by the legal charge. By this collateral contract, BOC promised the Fungs that their liability would be limited to HK\$3.3 million, in consideration of the Fungs executing the bank's standard form legal charge to secure SMC's indebtedness. On the basis of this collateral contract, his Lordship ordered that judgment be entered for the bank against the Fungs in the sum of HK\$3.3 million and that the bank be given possession of the flat charged under the legal charge.

In their judgments, the other members of the Court of Final Appeal expressly agreed<sup>4</sup> with the collateral contract analysis adopted by Litton NPJ, although they took the view that the evidence adduced in this case also supported the existence of a single composite contract (that is, a contract which is partly written and partly oral). They concluded the court would have reached the same result on this alternative analysis.

The decision may be fair and equitable in view of the circumstances of this case.<sup>5</sup> In getting to that result, however, the Court of Final Appeal appears to have departed from the traditional, more cautious approach towards

<sup>4</sup> Mr Justice Bokhary PJ (at para 1 of the BOC case (n 1 above)), Mr Justice Chan PJ (at para 2), Mr Justice Mortimer NPJ (at para 66) and Lord Cooke of Thorndon NPJ (at para 69).

<sup>5</sup> One may argue that the decision may not be fair and equitable as far as it concerns Mrs Fung, in view of the Court of Appeal's finding that she was subject to her husband's undue influence in executing the legal charge. The undue influence argument received only minimal treatment in the Court of Final Appeal judgment. However, for the purposes of this article, it is assumed that there is no undue influence which gave Mrs Fung the right to set aside the legal charge.

collateral contracts. In addition, it is not easy to reconcile this decision with cases where banks' security interests have been set aside for misrepresentation.

### The Collateral Contract Analysis

#### *Judicial Approach to Collateral Contracts*

Lord Moulton's speech in *Heilbut, Symons & Co. v Buckleton*<sup>6</sup> is probably the most well-known judicial pronouncement on collateral contracts:<sup>7</sup>

"It is evident both on principle and on authority, that there may be a contract the consideration for which is the making of some other contract. 'If you will make such and such a contract I will give you one hundred pounds,' is in every sense of the word a complete legal contract. It is collateral to the main contract, but each has an independent existence and they do not differ in respect of their possessing to the full the character and status of a contract."

Lord Moulton recognised, however, that the effect of such a collateral contract could well be the modification of the terms of the main contract, and that "the more natural and usual way of carrying this out would be by so modifying the main contract and not by executing a concurrent and collateral contract".<sup>8</sup> Therefore, his Lordship hastened to add a word of caution:

"Such collateral contracts, the sole effect of which is to vary or add to the terms of the principal contract, are therefore viewed with suspicion by the law. They must be proved strictly. Not only the terms of such contracts but the existence of an *animus contrahendi* on the part of all the parties to them must be clearly shewn. Any laxity on these points would enable parties to escape from the full performance of the obligations of contracts unquestionably entered into by them and more especially would have the effect of lessening the authority of written contracts by making it possible to vary them by suggesting the existence of verbal collateral agreements relating to the same subject-matter."<sup>9</sup>

The Privy Council showed the same degree of caution many years later when hearing an appeal from Hong Kong. In *Universal Dockyard Ltd v Trinity*

<sup>6</sup> [1913] AC 30.

<sup>7</sup> *Ibid.*, p 47.

<sup>8</sup> *Ibid.*

<sup>9</sup> *Ibid.*

*General Insurance Co. Ltd*,<sup>10</sup> the Privy Council reiterated the principle that collateral contracts the sole effect of which was to vary or add to the terms of the principal contract had to be strictly proved. Not only the terms of the alleged collateral contract, but also the existence of an *animus contrahendi* on the part of all the parties had to be shown clearly. On the evidence available before them, their Lordships refused to hold that the telephone conversations had given rise to a collateral contract between the parties.

The Hong Kong courts, following Lord Moulton's approach in *Heilbut*, have been somewhat reluctant to uphold collateral contracts. There are numerous cases where the courts have refused to hold that the oral assurances given amounted to collateral contracts, on the ground that clear and unequivocal evidence was lacking to prove the existence of such contracts or the intention to create them.<sup>11</sup> There were judicial dicta<sup>12</sup> which warned of the danger of opening the floodgate to the challenge of written contracts, especially in times of a volatile property market, and emphasised the importance of examining each case with care to see whether it comes within the collateral contract exception to the "parol evidence rule". In *Ip Ming Wai & Another v World Ford Development Limited*,<sup>13</sup> the Hong Kong Court of Appeal (comprising Litton and Bokhary JJA, as they then were) cited with approval Lord Moulton's statement in *Heilbut* that collateral contracts should be viewed with suspicion, and also expressly agreed with the Privy Council's approach in *Universal Dockyard*.

Meanwhile the English courts have been more prepared to uphold collateral contracts.<sup>14</sup> Lord Denning MR went so far as to say that what was said by the House of Lords in *Heilbut* about collateral contracts was "entirely out of date".<sup>15</sup> Today, the collateral contract is widely recognised as a well-established exception to the "parol evidence rule",<sup>16</sup> a view which was shared by the English Law Commission.<sup>17</sup> However, it appears that recently English law may have "turned full circle". Despite Lord Hoffman's more

<sup>10</sup> [1989] 2 HKLR 160.

<sup>11</sup> *Leung Yuk Chuen v Chan Fu Choi Joise*, unrep., CACV No 102 of 1992; *Bank of India v Surtani Murlidhar Parmanand t/a Ajanta Trading Corporation* [1994] 1 HKC 7; *Man Keung Company Limited v Prosperity Machinery Manufacturers Limited*, unrep., HCA No 12158 of 1997.

<sup>12</sup> See the judgment of Penlington JA in *Cheuk Tze Kwok v Leung Yin King & Another* [1993] 2 HKLR 169.

<sup>13</sup> [1993] 1 HKC 98.

<sup>14</sup> For example, collateral contracts were upheld in *Walker Property Investments (Brighton) Ltd v. Walker* [1947] 177 LT 204; *Dick Bentley Productions Ltd & Another v Harold Smith (Motors) Ltd* [1965] 1 WLR 623; *City and Westminster Properties (1934) Ltd v Mudd* [1959] Ch 129; *Esso Petroleum Co. Ltd v Mardon* [1976] 2 WLR 583; and *Record v Bell* [1991] 4 All ER 471.

<sup>15</sup> *J. Evans & Sons (Portsmouth) Ltd v Andrea Merzario Ltd* [1976] 1 WLR 1078, p 1081.

<sup>16</sup> See, for example, Treitel, *The Law of Contract* (London: Sweet & Maxwell, 10th edn, 1999), pp 182-183 and K. W. Wedderburn, "Collateral Contracts" (1959) CLJ 58.

<sup>17</sup> Law Commission Report No 154 (Cmd 9700, 1986), p 19.

liberal approach to the interpretation of contracts,<sup>18</sup> the English courts have recently displayed a certain disinclination towards collateral contracts.<sup>19</sup>

*The Collateral Contract in the BOC Case*

On the evidence presented, the Court of Final Appeal found that there was a collateral contract between BOC and the Fungs which existed alongside the main contract (that is, the legal charge). In this collateral contract, BOC agreed to limit the Fungs' liability to HK\$3.3 million if the Fungs would execute the bank's standard form all-monies legal charge over their flat as security for SMC's indebtedness. To support his collateral contract analysis, Litton NPJ relied heavily on that paragraph (quoted above on page 10) in BOC's instructions to Mr Lo which contained the phrase "for the time being agreed at HK\$3,300,000". To his Lordship, this pointed to an agreement between BOC and the Fungs to limit their liability to HK\$3.3 million.

It was clear from the evidence that there was an agreement between Mr Fung, Mr Ngan and Mr Lau regarding the obtaining of refinancing from BOC, and Mr Lo was privy to this agreement. It was also clear from the evidence that the Fungs, Mr Ngan and Mr Lau expected the Fungs' liability to be around HK\$3.3 million. What was not so clear, however, was whether the agreed limit mentioned in that paragraph referred to the maximum extent of facilities which BOC initially agreed to make available to SMC, or the maximum extent of the Fungs' liability to BOC. If it was the latter, one further question became relevant: had BOC ever agreed to bind itself to this limit *vis-à-vis* the Fungs?

It was pointed out in the Court of Final Appeal's judgment that the Fungs and the bank had never met. Any agreement which might have been entered into between the Fungs and the bank must therefore have been through the agency of SMC, Mr Ngan and Mr Lau. There was no evidence of any specific promise or assurance given to the Fungs by any of the bank's officers. In fact, the issue of a collateral contract was not even raised or argued by any of the counsel in the BOC case. Far from requiring strict proof of the existence of a collateral contract, it would appear that the Court of Final Appeal took the initiative in constructing a collateral contract out of the very limited evidence presented before it. Such a liberal and proactive approach is a far cry from the cautious approach advocated in *Heilbut* and *Universal Dockyard* and consistently adopted by the Hong Kong courts. This change in judicial attitude is particularly surprising in light of the many cases in recent years where

<sup>18</sup> *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896, referred to in para 59 of Litton NPJ's judgment in the BOC case (n 1 above).

<sup>19</sup> See, for example, *Jonathan Wren & Co. Ltd v Microdec plc* 65 Con LR 157 and *Ellis Tylin Ltd v Operative Retail Services Ltd* [1999] BLR 205, where the courts refused to hold there were any collateral contracts in the absence of clear and unequivocal evidence to support the same.

desperate mortgagors have tried every possible defence to prevent banks from repossessing their homes. Allegation of an oral collateral contract would at least raise a triable issue. This would give the mortgagors an opportunity to stop banks from obtaining summary judgment against them, and thus delay enforcement proceedings. In this connection, it is worth noting that one of the justifications for the parol evidence rule (to which the collateral contract is an important exception) is that it would save time and costs in the conduct of litigation by excluding extrinsic evidence irrelevant to the contract. There is perhaps good reason why collateral contracts should be “viewed with suspicion” even now.

It is also worth noting that the term embodied in the oral collateral contract in the *BOC* case is a term central to the transaction. It concerned the amount secured by the mortgage – a term central to both the creation of the mortgage and its redemption. In *The Nile Rhapsody*,<sup>20</sup> despite his finding that an oral agreement existed between the parties, Hirst J refused to hold that there was a collateral contract because evidence showed that “this oral agreement, far from being separate from the main transaction, was central to it”.<sup>21</sup> A similar argument was put forward by Treitel.<sup>22</sup> It is submitted that this argument is a forceful one. If the law seeks to give effect to the manifested intention of the contracting parties, then would it not appear odd that the parties would have chosen to use a collateral contract to deal with a term which is central to the transaction, rather than have that term embodied in the main contract itself? Clear and unequivocal evidence should be required to support a finding of collateral contract in such cases. In the *BOC* case, it would appear strange that the parties would have chosen to deal with the secured amount in a separate but concurrent contract without making even the slightest attempt to negotiate for its inclusion in the legal charge itself.<sup>23</sup>

One interesting issue was not addressed by the Court of Final Appeal in the *BOC* case. It has been suggested that the collateral contract analysis and the single composite contract analysis are almost interchangeable.<sup>24</sup> In most

<sup>20</sup> [1992] 2 Lloyd's Law Reports 399.

<sup>21</sup> *Ibid.*, p 407.

<sup>22</sup> Treitel, *The Law of Contract* (n 16 above), pp 164–165. Treitel argues that in cases where the legislature has prescribed certain formalistic requirements for a contract, if the courts allow an essential term of that contract to be embodied instead in a collateral contract, this would in effect defeat the purpose of the legislation. In this regard, it is worth noting that s 44(1) of the Conveyancing and Property Ordinance (Cap 219) provides that a mortgage of a legal estate in land may only be effected by a charge by deed expressed to be a legal charge. The legal charge in the *BOC* case is subject to this requirement.

<sup>23</sup> Compare *City and Westminster Properties (1934) Ltd v Mudd* (n 14 above), where the landlord refused the tenant's request to have the covenant against dwelling removed from the lease, but promised not to enforce it against the tenant if the tenant executed the lease in that form. Such a promise was held to give rise to a collateral contract.

<sup>24</sup> Cheshire, Fifoot and Furmston's *Law of Contract* (London: Butterworths, 13th edn, 1996), p 135. See also Law Commission Report No 154 (n 17 above), p 19.

cases,<sup>25</sup> the same result is reached irrespective of which analysis is adopted. However, it has been suggested<sup>26</sup> that a distinction can be made where third party rights are involved, for example, where there has been an assignment of the contractual rights. This point could have been relevant in the BOC case if there had been an assignment by The China State Bank, Limited to BOC of its contractual rights, instead of a merger of the banks by statute. As it transpired, the Court of Final Appeal was not required to deal with the assignment issue, and it remains to be seen whether third party rights would call for a different judicial approach.

### Relationship with Misrepresentation

#### *Treatment of Misrepresentation in the BOC Case*

The Fungs pleaded misrepresentation as a defence before the Master. They argued that BOC's lawyer had misrepresented to them the effect of the legal charge at the time they executed it. This argument was rejected by the Master. In the Court of Appeal, Rogers VP found that the paragraph (quoted above on page 10) in BOC's instructions to its solicitors (which was somehow faxed to Mr Fung via SMC) amounted to a representation by the bank to the Fungs as to the effect of the document they were to sign.<sup>27</sup> This, in Rogers VP's view, was a misrepresentation.<sup>28</sup> The Court of Appeal allowed the Fungs' appeal on the ground, *inter alia*, that, following Lord Browne-Wilkinson's approach in *Barclays Bank plc v O' Brien*,<sup>29</sup> there was a legal and equitable wrong which entitled Mrs Fung to set aside the legal charge.<sup>30</sup>

Though his Lordship disagreed with the Court of Appeal's ruling, Litton NPJ adopted Rogers VP's finding that BOC had made a representation to the Fungs when a copy of the bank's instructions to Mr Lo was faxed to Mr Fung by SMC. However, Litton NPJ found that this was a representation by BOC as to the *true* effect of the document which Mr Lo was instructed to prepare, and was therefore not a *misrepresentation*.<sup>31</sup> Litton NPJ simply left the misrepresentation issue at that and moved on to state that the proper legal approach should be that of a collateral contract. No attempt was made to

<sup>25</sup> For example, in *J. Evans & Sons (Portsmouth) Ltd v Andrea Merzario Ltd* (n 15 above), Lord Denning MR found there was a collateral contract, whilst Roskill and Geoffrey Lane LJ found the contract to be partly oral and partly written.

<sup>26</sup> Cheshire, Fifoot and Furmston, *Law of Contract* (n 24 above), p 135.

<sup>27</sup> See para 31 of the Court of Appeal's judgment in *The China State Bank Ltd v Fung Chin Kan and Others* [2001] HKCA 220.

<sup>28</sup> *Ibid.*, para 67.

<sup>29</sup> [1994] AC 180, p 196.

<sup>30</sup> Paras 67–68, *The China State Bank Ltd v Fung Chin Kan and Others* (n 27 above).

<sup>31</sup> Para 52 of the BOC case (n 1 above).



analyse any of the cases<sup>32</sup> where banks' security had been challenged because of some pre-contractual statements. Instead, Litton NPJ relied on a tenancy case<sup>33</sup> to support his collateral contract analysis. To the collateral contract analysis, the only relevance of the representation was whether, on the totality of the evidence, the parties have intended the representation to form part of the basis of the legal relationship between them.<sup>34</sup> Whilst this is the correct test to apply in determining whether a representation has become a contractual term, it is not apparent from the Court of Final Appeal's judgment that this test had been duly applied in the BOC case. After stating what the correct test should be and without referring to any additional evidence, Litton NPJ immediately concluded that there was a collateral contract between BOC and the Fungs, whereby BOC agreed to limit the Fungs' liability to HK\$3.3 million in consideration of the Fungs executing the bank's standard form of mortgage.<sup>35</sup> There might have been strong evidence before his Lordship which supported a collateral contract analysis. Unfortunately, it is not apparent from his Lordship's judgment what evidence there was in addition to that paragraph in BOC's instructions which led his Lordship to the collateral contract conclusion. The conclusion therefore appears rather hasty and unconvincing.<sup>36</sup>

#### *Was There a "Representation"?*

With due respect, it is not easy to construe a "representation" out of the relevant paragraph in BOC's instructions to Mr Lo. First, the wording is too ambiguous and imprecise – the agreed amount could have referred to the amount of facilities agreed to be provided to SMC rather than the Fungs' liability. Secondly, the bank's letter of instruction to its own lawyers seems the least likely place for making a representation to the mortgagors, if one was ever intended. It was purely fortuitous that a copy was faxed to Mr Fung by SMC. Nothing seemed to indicate that BOC intended the instructions to be sent to the Fungs. The BOC case could be better understood if the Court of Final Appeal had found that, instead of constituting a representation, BOC's instructions only indicated there must have been some discussions with the bank regarding the Fungs' liability (that is, it was merely one piece of evidence which pointed to the possible existence of an agreement between the bank and the Fungs). It would appear that further (and more convincing)

<sup>32</sup> These cases are discussed at pp 18–20 below.

<sup>33</sup> *Walker Property Investments (Brighton) Ltd v Walker* (n 14 above).

<sup>34</sup> Para 57 of the BOC case (n 1 above).

<sup>35</sup> *Ibid.*, para 58.

<sup>36</sup> Chan PJ did refer to the failure on BOC's part to enforce a "top-up" clause in the legal charge. To his Lordship, this showed that BOC never intended to look to the Fungs for an amount in excess of HK\$3.3 million.

evidence would be required to justify a finding that there was an assurance which, coupled with the presence of the necessary *animus contrahendi*, had given rise to a collateral contract.

Herein lies the difficulty faced by the Court of Final Appeal. There was a dearth of communication between the bank and the Fungs. There was no shortage of evidence which pointed to an agreement between the Fungs on the one part and Mr Ngan, Mr Lau and SMC on the other, but not so as between the Fungs and BOC. Other than that paragraph in the bank's instructions, it was not apparent what representation the bank had made. Of course, in the absence of any representation by the bank to the Fungs, the entire collateral contract argument would fall away.

*If There Was a Representation, What Was BOC Representing?*

Assuming the paragraph in BOC's instructions constituted a representation, what was BOC representing? Litton NPJ said it was a representation as to the true effect of the document which it had instructed its lawyers to prepare.<sup>37</sup> Was it then a representation of *law* (as to the legal effect of the document) or of *fact* (that the bank had issued such instructions to its lawyers)? Was it a representation of *intention*? If it was a representation of intention, was it an intention to hold the Fungs liable for only HK\$3.3 million notwithstanding that the mortgage would be for an unlimited amount, or an intention to have a mortgage prepared which would contain a monetary limit of HK\$3.3 million? Or was it a representation of the fact that the bank held such an intention at that point in time? None of these issues was addressed by the Court of Final Appeal. Presumably, they were not considered relevant once the court concluded it was not a misrepresentation. However, it is submitted that these are relevant issues which should have been considered. If it was not clear what exactly BOC was representing to the Fungs in the instructions, how could one have concluded it was not a misrepresentation? And it was on this same representation that the Court of Final Appeal had found a collateral contract.

*The Misrepresentation Cases*

It is interesting to examine the Court of Final Appeal's decision in the BOC case against the backdrop of cases involving misrepresentation and its effect on banks' security interests.

The leading cases are *Barclays Bank plc v O'Brien*<sup>38</sup> and *Royal Bank of Scotland v Etridge (No 2)*.<sup>39</sup> In *O'Brien*, Lord Browne-Wilkinson said, in relation to the effect of misrepresentation on a bank's security interest:<sup>40</sup>

<sup>37</sup> Para 52 of the BOC case (n 1 above).

<sup>38</sup> See n 29 above.

<sup>39</sup> [2001] 4 All ER 449.

<sup>40</sup> At pp 195–196.

“Therefore where a wife has agreed to stand surety for her husband’s debts as a result of undue influence or misrepresentation, the creditor will take subject to the wife’s equity to set aside the transaction if the circumstances are such as to put the creditor on inquiry as to the circumstances in which she agreed to stand surety.”

In *TSB Bank plc v Camfield*,<sup>41</sup> both Lord Justice Nourse<sup>42</sup> and Lord Justice Roch<sup>43</sup> relied heavily on this passage to justify their decision. Mr Camfield told his wife that their liability to the bank would be limited to £15,000 when, in fact, the mortgage they were to execute was for an unlimited amount. The bank argued that the wife should still remain liable for £7,500 (being her half share of the £15,000 for which she intended to be liable). The English Court of Appeal held that there was a misrepresentation by the husband to his wife and that the bank had failed to discharge its duty of enquiry and thus had constructive notice of the wife’s right in equity to rescind. It rejected the bank’s argument on partial rescission and upheld the misrepresentee’s right to rescind the contract in its entirety. Nourse LJ stated that rescission should be “an all or nothing process”.<sup>44</sup> Roch LJ explained that the right to set aside a transaction for misrepresentation belonged to the misrepresentee and not the court. Thus, the court had no place to intervene by imposing conditions on rescission.<sup>45</sup> The English Court of Appeal’s extreme reluctance in *Camfield* to intervene was probably rooted in its firm belief that courts should shy away from altering or rewriting contracts.

A bank’s duty of enquiry in wife surety cases has since been clarified by the House of Lords’ decision in *Royal Bank of Scotland v Etridge (No 2)*.<sup>46</sup> The *Etridge* decision concerns a bank’s duty of enquiry in cases where a wife stands surety for the indebtedness of her husband or his business. The House of Lords held that, in such a case, the bank’s duty extends only to the taking of reasonable steps to satisfy itself that it has been explained to the wife, in a meaningful way, the nature and effect of the proposed transaction, if the bank does not wish the wife to be able to subsequently challenge the transaction on the ground of misrepresentation or undue influence by her husband. In this respect, *Etridge* is not directly applicable to the *BOC* case, since the so-called “representation” in the *BOC* case was made by the bank itself, and not by the husband. However, it is worth noting that in *Etridge*, the House of Lords appreciated banks’ concerns that wife sureties may subsequently challenge

<sup>41</sup> [1995] 1 WLR 430.

<sup>42</sup> *Ibid.*, p 434.

<sup>43</sup> *Ibid.*, p 438.

<sup>44</sup> *Ibid.*, p 436, quoting Ferris J in *Allied Irish Banks plc v Byrne* [1995] 1 FCR 430, p 462.

<sup>45</sup> *Ibid.*, p 438.

<sup>46</sup> See n 39 above.

the transaction on the basis of assurances allegedly given by the bank officers concerned, and hence refused to require banks to personally explain the effect of the transaction to the wife sureties.<sup>47</sup> In the light of this and the House of Lords' general approach in *Etridge*, it is surprising that the Court of Final Appeal so readily found that paragraph in BOC's instructions to amount to a representation by the bank and that a collateral contract subsisted between the bank and the Fungs, when the bank had hardly held any discussions with the couple.

The *Camfield* approach was followed in Hong Kong in *Hua Chiao Commercial Bank Ltd v Yang Hsiang Yang*.<sup>48</sup> This case concerned a Mr Tsoi who traded under the name of Asia Trading Company. Mr Tsoi banked with Hua Chiao Commercial Bank Ltd (HCCB) and owed the bank some money under a trust receipt facility. Mr Yang was a friend of Mr Tsoi and allowed himself to be persuaded by Mr Ngaw, the manager of HCCB's North Point branch, to charge his property to HCCB as security for Mr Tsoi's debt. The court found that Mr Ngaw represented to Mr Yang that his liability under the charge would be limited to HK\$400,000, but Mr Yang was subsequently asked to execute a charge under which his liability was unlimited. The court held there was a misrepresentation by HCCB and, following *Camfield*, dismissed the bank's claim in its entirety.

Whilst the English courts adhere strictly to the "all or nothing" approach to rescission, the High Court of Australia in *Vadasz v Pioneer Concrete (SA) Pty Ltd*<sup>49</sup> has allowed partial rescission of a guarantee. Vadasz executed a guarantee in favour of Pioneer Concrete in respect of debts owed by a third party to Pioneer Concrete. Pioneer Concrete represented to Vadasz that he would only be liable for indebtedness incurred after the date of the guarantee. The guarantee in fact covered both existing and future indebtedness. Notwithstanding the supplier's misrepresentation, Vadasz was still held liable under the guarantee, but only to the extent of indebtedness incurred after the execution of the guarantee.

Having found that there was no misrepresentation, the Court of Final Appeal in the *BOC* case did not consider any of these cases.

#### *Misrepresentation Versus Collateral Contract*

Where a bank has given a mortgagor an assurance that his liability under the mortgage would be limited to a certain amount, but the actual mortgage is expressed to be for an unlimited amount, what are the parties' respective

<sup>47</sup> *Ibid.*, p 468.

<sup>48</sup> [1995] HKCFI 416.

<sup>49</sup> (1995) 184 CLR 102.

legal positions? The *BOC* case highlights the importance of differentiating a misrepresentation from a collateral contract, because it makes a world of difference to the end result, especially for a mortgagor desperate to keep a roof above his head. If the bank has given an assurance (which amounts to an actionable misrepresentation) to the mortgagor as to the extent of his liability, the mortgage may be set aside in its entirety by the mortgagor (such as in the *Yang* case). However, if the bank has given an assurance to the mortgagor as to the extent of his liability and that assurance amounts to a collateral contract but not a misrepresentation, then the mortgage may still be enforced, but only up to the extent indicated in the assurance (such as in the *BOC* case). This distinction between misrepresentation and collateral contract rests solely upon judicial construction of pre-contractual statements made by the parties, and allows considerable scope for arbitrariness.<sup>50</sup>

Perhaps the *BOC* case can be explained as one which was decided on its very special facts. The “representation” was contained in the bank’s instructions to its own lawyers; it was not meant for the Fungs. This was perhaps sufficient to show that the bank had no intention to use this document to *mislead* the Fungs, a factor which might have influenced their Lordships in concluding there was no misrepresentation.

Since the “representation” was contained in *BOC*’s instructions to its lawyers, Litton NPJ concluded that it was a representation as to *the effect of the document which the bank had instructed its lawyers to prepare*. What does that mean? To the extent that the paragraph describes a document which *BOC* instructed its lawyers to prepare, there can be nothing untrue in it, so in this respect his Lordship was correct in finding that there was no misrepresentation. However, this is not the only possible interpretation of that paragraph in *BOC*’s instructions. In fact, as far as the representees were concerned, this might not be the message they received at all. What concerned them was their liability under the document they were to execute, not what instructions the bank had given to its lawyers. If that paragraph in *BOC*’s instructions amounted to a representation to the Fungs that the liability under the mortgage document which *they were to execute* would be limited to HK\$3.3 million, then it would have been misleading.

With due respect, to categorise that paragraph in *BOC*’s instructions as a representation as to the true effect of the document which the bank has instructed its lawyer to prepare is completely artificial. If that paragraph

<sup>50</sup> It has been said that “[t]he question whether any particular statement is a mere representation or a term of contract is frequently a difficult one for the court” (*Chitty on Contracts*, Vol 1 (London: Sweet & Maxwell, 28th edn, 1999), para 12.003). According to *Chitty*, the court will take into account a variety of considerations, none of which is conclusive. The cases are also difficult to reconcile with each other. Compare *Dick Bentley Productions Ltd v Harold Smith (Motors) Ltd* (n 14 above); *Oscar Chess Ltd v Williams* [1957] 1 WLR 370 and *Beale v Taylor* [1967] 1 WLR 1193.

amounted to any representation to the Fungs at all, it would have been a representation that, notwithstanding that the legal charge to be executed by the Fungs would cover all monies owing by SMC, the bank would hold them liable for not more than HK\$3.3 million. In other words, it would be a representation as to BOC's intention.

Both the *Yang* case and the *BOC* case concern representations as to a party's liability under a document which was not yet in existence at the time the representation was made. In a way, the statement made could never have been incorrect, since the document was then not yet in existence. One may attempt to distinguish the *Yang* case on the basis that the HCCB manager never intended to limit Mr Yang's liability to HK\$400,000 despite what he told Mr Yang. He was therefore representing an intention which he did not have, and hence it was a misrepresentation.<sup>51</sup> In the *BOC* case, however, the Court of Final Appeal found that BOC did intend to limit the Fungs' liability to HK\$3.3 million at the time the bank made a "representation", though things turned out quite differently. There was, therefore, no misrepresentation as to the bank's intention. If that is the real distinction between the two cases, then the crucial question appears to be this: did the maker of the pre-contractual statement really mean what he said when he said it? If he did not, the case is one of misrepresentation, so the *Yang* case applies, and the contract must be set aside in its entirety. On the other hand, if he did mean what he said when he said it, there was no misrepresentation; however, if he later changed his mind, he may be in breach of a collateral contract (if what he said has given rise to one), but the main contract may still be enforced up to the "agreed" amount on the authority of the *BOC* case. The same representation might have been made regarding the effect of a document to be executed, but the state of mind of the representor at the time of the representation would make the end result completely different. This may be a perfectly valid distinction to make in theory, but it is a distinction which is extremely difficult to apply in practice, and one which is prone to cause severe hardship. The difficulty of proving a person's subjective intention is well known, and such a dichotomy in approach would likely cause headaches amongst practitioners asked to advise clients as to their legal position. This is particularly worrying in light of the Court of Final Appeal's new-found zeal towards collateral contracts. Litigation may become more costly and protracted when a full hearing is required for witnesses to be cross-examined and other evidence to be adduced for what could have been a simple application by a mortgagee for possession of the mortgaged property. In light of this, it is hoped that the *BOC* case is a stand-alone decision which turned on its very special facts.

<sup>51</sup> A statement of a person's own intention is a representation of fact, and therefore actionable: see Treitel (n 16 above), pp 305-307.

### *Partial Rescission*

By framing the issue as one of collateral contract and not misrepresentation, the Court of Final Appeal has ingeniously avoided the tricky issue of whether partial rescission should be allowed. The issue of *restitutio in integrum* as a requirement of rescission was raised by counsel for BOC, but the Court of Final Appeal did not find it necessary to rule on that point in the absence of any misrepresentation in that case.<sup>52</sup> In so doing, the Court of Final Appeal missed a golden opportunity to express its view on whether the court has power to impose terms on a rescission. So far, English courts have not allowed partial rescission,<sup>53</sup> though there has been judicial dicta<sup>54</sup> which favoured such an approach. In contrast, the High Court of Australia in *Vadasz*<sup>55</sup> has allowed partial rescission. It remains to be seen whether the Hong Kong judiciary will join their Australian counterparts in adopting a more liberal approach towards rescission, when the Court of Final Appeal has seen fit to liberate itself from its previous cautious approach towards collateral contracts.

### **An Alternative Approach?**

It is submitted that a just and equitable result could have been reached in the BOC case without straining the frontiers of the collateral contract or blurring its boundary with misrepresentation. If the parties had in fact intended Mr Lo to insert the "agreed" HK\$3.3 million limit in the legal charge, this might have been a case for rectification of the legal charge to reflect the parties' true intention,<sup>56</sup> rather than a case of collateral contract. In *The Nile Rhapsody*,<sup>57</sup> Hirst J held that the court had power to treat an agreement as rectified, without actually making an order for rectification of the document. If a party can prove that: (a) there was a prior agreement; (b) such agreement was still effective when the contract was concluded; (c) by mistake the contract failed to carry out that agreement; and (d) if rectified, the document would carry out that agreement, then the document would be treated as rectified.<sup>58</sup> Applying this four-fold criteria to the BOC case, if BOC and the Fungs had agreed upon a HK\$3.3 million limit on the Fungs' liability and that such

<sup>52</sup> See paras 62–63 of the BOC case (n 1 above).

<sup>53</sup> *TSB Bank plc v Canfield* (n 41 above), and *De Molestina v Ponton* [2002] 1 Lloyd's Rep 271, pp 286–287.

<sup>54</sup> See Lord Justice Miller's speech in *Dunbar Bank plc v Nadeem* [1998] 3 All ER 876, p 884–885.

<sup>55</sup> See n 49 above.

<sup>56</sup> Rectification of a document is permissible where there has been a mistake in recording the parties' oral agreement. For a discussion on rectification of a document, see Treitel, *The Law of Contract* (n 16 above), p 182.

<sup>57</sup> See n 20 above.

<sup>58</sup> *Ibid.*, p 409. Hirst J's ruling on rectification was affirmed by the Court of Appeal: [1994] 1 Lloyd's Rep 382, pp 390, 392.

limit be set out in the legal charge, that agreement being still effective at the time the legal charge was executed, but by mistake the legal charge had omitted the agreed limit, then it would appear that, if rectified, the legal charge would carry out the parties' agreement. If this is the case, the *BOC* case could have been one for rectification and, on the authority of *The Nile Rhapsody*, a court may exercise its power to treat the legal charge as rectified (and enforce it as such) without making a rectification order. This approach should achieve the same just result in the *BOC* case as that reached by the Court of Final Appeal.

One commentator<sup>59</sup> has said that the *Vadasz* approach towards rescission has "very much the effect of rectification".<sup>60</sup> Perhaps it would have been more straight-forward to dispose of the *BOC* case by adopting the *Nile Rhapsody* approach to rectification than venturing into the murky waters of misrepresentation, collateral contracts and partial rescission. Indeed, Litton NPJ probably had rectification in mind when he quoted<sup>61</sup> from Lord Hoffmann's speech in *Investors Compensation Scheme v West Bromwich*.<sup>62</sup>

"... if one nevertheless concludes from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had."

However, since none of the parties in the *BOC* case put forward this argument, and *BOC* never accepted that there was a mistake in the preparation of the legal charge, Litton NPJ thought it would "transcend the frontiers of judicial boldness for the court to attempt to do so".<sup>63</sup> He was thus happy to deal with the appeal on the collateral contract analysis. With due respect, if *BOC*'s instructions did indicate the parties' intention to contract on the basis that the Fungs' liability be limited to HK\$3.3 million, it would have been more probable for them to intend that the limit be embodied in the legal charge than in an oral collateral contract. Hence, there was probably a stronger case for rectification than for a collateral contract.

## Conclusion

In the *BOC* case, the Court of Final Appeal has attempted to achieve substantive justice between the parties. By adopting the collateral contract

<sup>59</sup> Proksch (1996) RLR 71.

<sup>60</sup> *Ibid.*, p 78.

<sup>61</sup> At para 59 of the *BOC* case (n 1 above).

<sup>62</sup> See n 18 above, p 913.

<sup>63</sup> At para 59 of the *BOC* case (n 1 above).



analysis, the court has managed to avoid the draconian step of setting aside the legal charge in its entirety, and achieve substantive justice by holding the parties to what the court believed they had agreed. The Fungs agreed they would be liable under the legal charge for up to HK\$3.3 million, so this was the amount for which they were eventually held liable.

It is unfortunate, however, that the Court of Final Appeal decision did not throw light on how pre-contractual statements as to a person's liability under that contract are to be dealt with thenceforth. The present legal position is far from satisfactory. The outcome can be quite different depending on whether the court is inclined towards a misrepresentation analysis or a collateral contract analysis, and on the subjective state of mind of the maker at the time the statement was made. A party will hardly know where it stands legally, short of bringing the matter to court for a final adjudication.

The BOC case is also notable for the great leap forward which the Court of Final Appeal took as regards collateral contracts. Whilst none of the counsel argued this point, the court surprisingly took the initiative of finding a collateral contract amidst the "matrix of facts leading to the transaction".<sup>64</sup> It remains to be seen whether the Hong Kong judges will continue with this proactive approach when their brethren in England seem to be reverting to a more conservative one. It will be interesting to see also whether the Hong Kong judiciary will be equally liberal in their attitude toward partial rescission.

<sup>64</sup> As per Lord Hoffman in the *Investors Compensation Scheme Ltd* case (n 18 above).

