Asia Pacific Guide to Lending and Taking Security - Hong Kong SAR

If taking security

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# 1. Are there any classes of unsecured and unsubordinated creditor whose claims against a debtor would rank equally with or above those of the debtor’s secured creditors?

Secured creditors generally stand outside the order of priority of payments because they are entitled to be paid from the proceeds of their security. The exception is a creditor secured by a floating charge (discussed in the answer to question 3 of this section). Creditors secured by a floating charge rank below preferential creditors (e.g., employees and the government).

# 2. May security given by a company rank in a specified order so as to secure liabilities owed to different creditors of the company in that order and, if that is not possible, is it viable for parties to enter into a contractual arrangement for the purposes of moderating this order?

Yes, it is possible to contractually provide for a specified order of priority among different creditors. This is usually effected by the creditors and the debtor entering into a subordination agreement or an intercreditor deed.

# 3. Does this jurisdiction recognise the concept of floating security or similar equivalent (i.e., security over a changing pool of assets that the company giving the security is free to buy, sell and generally deal with)?

Yes. A floating charge allows the chargor to continue to deal with the charged assets in its ordinary course of business until the charge “crystallizes” into a fixed charge over the assets in existence at the point of crystallization, usually on a specified crystallization event.

# 4. If so, are there any practical reasons why floating security is difficult to take, maintain or enforce?

There are certain issues that a security holder needs to be aware of when taking a floating charge as security. On the insolvency of the chargor, the security granted by a floating charge ranks behind all fixed charges and behind the rights of certain preferential creditors (see the answer to question 1 of this section). On a winding-up of the chargor, a floating charge that was created within 12 months, or, in the case of a charge that was created in favor of a person connected to the chargor, within two years, of the commencement of the winding-up is invalid except to the extent of new consideration from the chargee, if any, unless it is shown that the chargor was solvent immediately after the creation of the floating charge.

However, contractual protections can be included in security documents to control and to mitigate against these types of risks, including the ability to automatically crystallize a floating charge into a fixed charge immediately on the occurrence of certain events (e.g., where insolvency proceedings against the chargor have commenced or where the lender considers that the assets subject to the floating charge may be in danger of being seized or otherwise be in jeopardy). On crystallization, a floating charge becomes a fixed charge and ranks as a fixed charge. This means that it would rank behind an earlier fixed charge but it would have priority over subsequent fixed charges and floating charges.

# 5. May security be granted to a trustee to be held on trust for the lenders from time to time, in such a way that a change of lenders does not require new security to be taken?

Yes.

# 6. If not, are there any techniques that can be used to achieve substantially the same effect (e.g., parallel debt structures)?

Not applicable.

# 7. If an agent holds security for the lenders rather than a trustee, is it necessary to take new security on a change of lenders? If no, why not? If yes, are there ways to structure the transaction to avoid such a requirement?

In Hong Kong secured lending transactions, the security agent usually acts as a trustee for the lenders, although the security agent may not necessarily be given the title of "trustee." If the security agent acts as an agent and not as a trustee, it would be necessary to consider the terms of the security agent's appointment and the agency provisions in the transaction documents to determine whether new security would be required on a change of lenders. Therefore, the simplest and most practical approach is for the security agent to always act as a trustee in relation to the security.

# 8. Under the laws of this jurisdiction, is there any class of asset over which it is difficult or impossible to grant effective and perfected security, or in relation to which any security granted will be of limited effect?

Security may be conferred over most assets that are likely to be of interest to lenders as security for a financing transaction. However, lenders should note the following:

Future assets (i.e., those not in existence at the time of entering into the security document) may only be made the subject of equitable security, such as a charge, and not legal security, such as a legal mortgage. In practice, the distinction is unlikely to be significant.

For a charge to be fixed (rather than floating), it is advisable for a lender to ensure that it exercises actual control over the charged assets so that the chargor is not permitted to freely deal with the assets as though they were not subject to the fixed charge. Otherwise, the security may be recharacterized as a floating charge. In practice, it is often difficult to take a fixed charge over inventory or trade receivables if they are trading assets of the chargor because the taking of a fixed charge is likely to be strongly resisted by a chargor.

Where security is taken over contractual rights, the underlying contract giving rise to the assigned rights must be examined to ensure that those contractual rights can be made the subject of security. Prohibitions on the assignment of those rights will invalidate any purported security over them. In addition, rights under contracts that are "personal" to the contracting parties (e.g., an employment contract) are not assignable.

In some cases, the involvement of a third party may be required before effective security can be granted. For example, it may be necessary to obtain a waiver or consent to the creation of the security from a contract counterparty.

In the case of land in Hong Kong, it is necessary to consider the land grant conditions to determine whether the grant of security over land is permitted or subject to any restrictions. The land grant conditions may prohibit the creation of security over the land (even where security is granted to finance the land acquisition cost) or may otherwise limit the persons to whom security may be granted. In addition, the land grant conditions in respect of certain Hong Kong real property may contain restrictions on alienation that require, for example, specific consents to be obtained from the Hong Kong government or a government-linked entity prior to security being created in favor of a lender. In those cases, the consent may limit the maximum amount that may be secured by the relevant security.

In the case of shares in a Hong Kong company, it is necessary to consider whether the articles of association of the company impose any restrictions on the grant of security over, or on the transfer of, those shares. The effectiveness of the security or a lender's rights to enforce that security may be compromised if the restrictions in relation to the transfer contained in the articles of association are not first altered or disapplied, or if any required consents are not obtained.

As a matter of public policy, generally, it is not possible to assign (by way of security) a bare right to sue or litigate.

# 9. Under the laws of this jurisdiction, are there any restrictions on offshore lenders taking security over any class of asset?

No, but see the responses to question 8 of this section (which would apply equally to an offshore lender wishing to take security).

# 10. Must a company receive a corporate benefit in return for giving a guarantee or security? In particular, are there restrictions on the grant of upstream and cross-stream guarantees and security? If yes, briefly what is the effect of these laws?

Directors of a Hong Kong company have a common law duty to act in the best interests of the company and to exercise powers and to take actions that benefit the company commercially. The Companies Registry of Hong Kong ("**Companies Registry**") has issued nonstatutory guidelines that outline general principles for directors in the performance of their functions that embody the requirement for directors to act in the best interests of the company.

When considering whether a company should provide a guarantee or security, the directors must therefore consider whether any commercial benefit will accrue to the company from the provision of that guarantee or security.

Generally, Hong Kong law does not recognize the concept of a group benefit. When a parent company gives a guarantee or grants security in respect of a subsidiary's obligations, the commercial benefit to the parent can be clearly established. However, when a subsidiary company gives a guarantee or grants security in respect of its parent's obligations or the obligations of another subsidiary of its parent (i.e., a "sister" company), it is often more difficult to establish what the commercial benefit is to the subsidiary.

Whether a company derives a commercial benefit from providing a guarantee or security is a factual matter for consideration in each particular case however, practical steps can be taken to reduce the risk of commercial benefit arguments being successfully raised by the most likely objectors (the company's shareholders and creditors). Assuming a guarantee or security is proposed to be granted by a solvent company, two key steps are obtaining the unanimous approval of the company's shareholders to the giving of the guarantee or the granting of the security and obtaining a statement from the company's directors that the company will not be unable to pay its debts as a result of the giving of the guarantee or the granting of the security. This will also protect the guarantee or security from being subsequently challenged as unenforceable on the basis that, for example, the directors used the powers conferred on them for an improper purpose or for a purpose not authorized by the company's articles of association (i.e., not in the best interests of the company), provided that the lender/chargee does not have actual knowledge of that impropriety.

Lastly, there are general presumptions in law that allow parties to presume that the transactions undertaken by a Hong Kong company are not *ultra vires* acts.

# 11. What type of security interests does your jurisdiction recognise, e.g., pledge, charge, mortgage, hypothecation? In relation to each type of security interest, please state the formalities required to create and perfect that security.

Types of security interests

The types of security interests typically used in financing transactions in Hong Kong include:

For shares, a legal or equitable mortgage or an equitable charge.

For real property, a legal charge.

For other immovable assets:
a fixed charge over specific assets.

For movable assets: a chattel mortgage, a floating charge, or a pledge - note that under Hong Kong law, a "pledge" is a "possessory security" and can only be created over movable assets, but not over immovable assets or intangible assets.

For bank accounts, book debts and contractual rights (such as rights to insurance and rights to trade receivables), an equitable or legal assignment, or a charge.

Generally, a floating charge over all or certain classes of assets.

Formalities

Security over specified assets of a company incorporated in Hong Kong or a company registered under the CO as a "non-Hong Kong company" must be registered with the Companies Registry within one month of the creation of the relevant security. Otherwise, the security will not be enforceable against any liquidator or creditor of the security provider.

In addition, in the case of a legal charge over real property or any other security document affecting land, the security interest must also be registered within one month of its creation with the Land Registry of Hong Kong ("**Land Registry**") to preserve its priority.

The registration of certain assets with other registries may also be necessary or advisable. See the answer to question 12 of this section for the registration requirements.

To perfect an assignment of debts and contractual rights, written notice of the assignment must be provided to the debtor or counterparty. For some classes of an asset (e.g., shares and other securities), it is common for lenders or security agents to hold in their possession and control any documents of title (e.g., title deeds), blank transfer forms and other ancillary documents (e.g., signed but undated resignation letters of the directors) to assist with the enforcement of the security and prevent unauthorized dealings by the chargor.

Security interests over real property must generally be made by way of deed and it is common for security over other kinds of assets to be made by deed.

# 12. Are there any registration, translation or notarization requirements in relation to security, guarantees, subordination or intercreditor documents?

If a document creates registrable security, it must be filed with the Companies Registry within one month of the date of its execution (and together with a certified translation, if the security document is not in Chinese or English). This registration requirement only applies to security created by companies incorporated in Hong Kong and any foreign company that is registered as a non-Hong Kong company (as referred to in the answer to question 11 of this section).

Where a foreign company (not a non-Hong Kong company) enters into a security document and the secured property is situated in Hong Kong, and the company subsequently becomes registered as a non-Hong Kong company under the CO, the registration of the security with the Companies Registry is required within one month of the date of the foreign company's registration as a non-Hong Kong company.

As mentioned in the answer to question 11 of this section, a legal charge over real property or any other security document affecting land must also be registered within one month of its creation with the Land Registry (and if the security document is not in Chinese or English, together with a Chinese or English translation to enable the Land Registry to determine whether the relevant registration requirements have been complied with).

Apart from the registration requirements referred to above, there may be different registration requirements in respect of certain types of assets (e.g., vessels and intellectual property) and in relation to different types of security providers (e.g., individuals).

There are no notarization requirements in relation to security, guarantee, subordination or intercreditor documents.

# 13. Are there any stamp, documentary, registration, notarization or other taxes, duties or fees chargeable in respect of security, guarantees, subordination or intercreditor documents? If yes, what are the amounts and when are they payable?

A registration fee of HKD 340 must be paid to the Companies Registry on the submission for the registration of each security document.

A registration fee of HKD 450 must be paid to the Land Registry on the submission for the registration of each security document (or HKD 230 if the amount or value of the consideration or value of the property or interest affected is less than HKD 750,000).

Other than the registration requirements and fees set out above and in the answer to question 12 of this section, no stamp duty or similar taxes or charges are payable in respect of security documents. However, in respect of a mortgage of shares in a Hong Kong company, nominal stamp duty of HKD 5 is payable on the execution of an instrument of transfer signed "in blank" (which lenders normally require). The execution enables the shares to be registered in the name of the lender (or its nominee) by converting an equitable share mortgage into a legal share mortgage. Stamp duty at a rate of 0.26% of the value of shares being transferred will be payable on the enforcement of the security. After the execution of an agreement for the transfer of shares, the parties should submit the relevant documents for stamping, if that agreement is executed in Hong Kong, within two days of signing; if it is executed outside Hong Kong, within 30 days of signing.

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