



Charging Order vs Margin Account – floating charge or fixed charge ?

Investing or trading stocks by means of margin financing via a margin account maintained with a securities house or money lender is very common in Hong Kong.

A recent case (*Bei Ni Ltd. V. Cornwell (Hong Kong) Ltd.* [2023] HKCFI 1799) is significant for and deserves the attention of institutions operating in the business of providing margin financing to stock investors via margin account services.

This legal case involves common legal issues which are frequently encountered. An account holder maintained a margin account with a securities house through which the account holder was able to trade in securities on margin. The account holder has acquired shares of listed company by means of margin financing via a brokerage and securities house. Subsequently a judgement creditor of the account holder obtained a charging order over the shares in the margin account (the “**Relevant Shares**”).

The issue for the Court to decide is who (i.e. the judgement creditor or the securities house) has priority over the Relevant Shares. The securities house argued that it has a charge over the Relevant Shares and it was not disputed that the share charge was created first in time whilst the judgement creditor argued that the charge in favour of the securities house was only a floating charge which was only crystallized after the charging order absolute and hence the judgement creditor should have priority over the security house in respect of the Relevant Shares. Hence, it boiled down to the issue as to whether the charge created under the margin account agreement was a fixed charge or a floating charge.

The nature of a floating charge has been explained by Buckley LJ in *Evans v Rival Granite Quarries Ltd*¹ as follows :-

“A floating charge is not a future security; it is a present security, which presently affects all the assets of the company expressed to be included in it A floating security is not a specific mortgage of the assets, plus a licence to the mortgagor to dispose of them in the course of his business, but is a floating mortgage applying to every item comprised in the security but not specifically affecting any item until some event occurs or some act on the part of the mortgagee is done which causes it to crystallize into a fixed security”

Since no specific asset is affected by the floating charge until crystallization, it follows that an execution creditor, which completes his execution and obtains a court decree before crystallization, gets priority.

For margin account agreement, normally there is a charging clause which provides for the creation of charge over the shares in the margin account while giving authority or flexibility to the account holder to trade the shares in the account and to dispose of the cash in the account to the order and direction of the account holder. This is the practical commercial reality, balancing the rights and obligations of the securities house and the account holder.

However, there comes the situation where a charging order over the shares in the account is obtained by a judgment creditor of the account holder. A question then arises as to whether the securities house or the judgement creditor obtaining the charging order would have priority over the shares in the account.

This is most important in the situation where the account holder is purchasing shares with the financial assistance from the securities house who in turn looks to the shares in the account as security for the repayment of the financial assistance provided to the account holder.

Therefore, the question would be whether the charge created by the agreement regulating the margin account is a fixed charge (which could withstand the charging order absolute) or a floating charge (which is vulnerable and rank subsequent to a charging order absolute).

¹ [1910] 2 KB 979 at 999



Key points to take away from the case of **Bei Ni Ltd. V. Cornwell (Hong Kong) Ltd.** :

1. It is well-established that to determine whether a charge is fixed or floating, the court will engage in a two-stage process. The first stage involves construing the terms of the contract. The second stage is one of characterization.
2. As far as the second stage is concerned, the three characteristics of a floating charge are :- *"(1) If it is a charge on a class of assets of a company present and future; (2) if that class is one which, in the ordinary course of the business of the company, would be changing from time to time; and (3) if you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way as far as concerns the particular class of assets I am dealing with."*²
3. As for the first stage, a fixed chargee must have sufficient legal control over the charged assets, namely the contractual right to prevent the chargor from withdrawing the charged assets from the scope of the security.³ Besides, if the securities house, under the terms and conditions of the margin account agreement, has positive legal control over the shares in the margin account such as stipulating that the shares can only be disposed of through a broker with the knowledge and consent of the securities house and at the same time has control over the sale proceeds when shares are sold, and applies the proceeds for its own benefit, then the charge created over the shares in the margin account shall be categorized as a fixed charge.

Here is the valuable lesson:

In the context of disputes involving multiple claims concerning a specific charge, it becomes imperative to determine the priority of each claim. The claim with the highest priority will be accorded the first discharge, making it crucial to establish and safeguard this priority. Failure to secure priority status may result in receiving no recovery or compensation whatsoever. Hence, securing and retaining priority over a charge assumes utmost significance in such legal proceedings.

For securities houses seeking comprehensive protection and segregation of their interests from other creditors concerning the account holders' accounts, it is crucial to have their margin account agreements thoroughly reviewed by experienced solicitors. This step will ensure that their rights are properly safeguarded and ringfenced against potential competing claims from other creditors. By adhering to the above principles, securities houses can better secure their interests and maintain greater control over the accounts held by their clients, offering an added layer of protection in the event of financial challenges.

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² Re Yorkshire Woolcombers Association Limited [1903] 2 Ch 284 at 295

³ Goode and Gullifer on Legal Problems of Credit and Security, 7th ed, §4-22



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