

The Concept of Hypothecation as a Secured Credit Instrument under International Business Law: an Appraisal

Michael Takim Otu

*Department of Private and Property Law,
University of Calabar*

Abstract

This article seeks to examine the concept of hypothecation within the international trading arena, notwithstanding misconceptions amongst academic pundits, lawyers, jurists and a dearth of reported cases as to the exact or true meaning of the concept. Thus, the article seeks to explain the nature and character of hypothecation, which quite often is regarded as an alternative name for a charge, which is an equitable interest in a secured chattel entitling the charge to attach that chattel or the proceeds there from for the settlement of the debt owed to him upon default of the chargor through insolvency or otherwise. Hypothecation is a security for a debt and nothing more and it cannot survive the debt. It is merely the shadow so to speak, cast by the debt upon the property of the debtor. The writer pointed out the fact that it is a misnomer to describe hypothecation as a 'lien' and ipso facto letters of hypothecation as 'letters of lien' or used interchangeably as it is sometimes called. The article analyze the fact that while both concepts share a common denominator in the sense of creating an in cumbrance over the goods in question as opposed to a transfer of either a proprietary or possessory interest in them, the concepts arise under different circumstance; for, while a charge in the form of hypothecation arises mainly by act of parties, a lien generally arises by operation of law or rules of equity from the relations between the parties. The writer concluded by justifying the fact that hypothecation has proven to be a more convenient and less cumbersome security devices as compared to the traditional legal mortgage. For instance, one basic difference between hypothecation and mortgage is that the charge unlike the mortgagee does not obtain any certain rights to the res upon creation of the hypothecation; rather such rights arose only upon default. These rights, even when they do arise, they are not ownership or dominion rights rather they belong to the wider class of proprietary rights. It is significant to point out that whereas both mortgages and possessory securities assign already existing rights in property but by hypothecation creates rights.

Keywords: *Statutory hypothecation, Judicial hypothecation, Charge, Lien, Mortgages, Security.*

Corresponding Author: Michael Takim Otu

Background to the Study

Securities may be classified into Mortgages, possessory liens and hypothecations. The concept of mortgage envisages the transfer of proprietary rights to the creditor. Although that may be an inadequate characterization since all securities to a great extent presuppose some proprietary right though not necessarily ownership right in the holder of the security. Sykes¹ links the threefold classification to the Roman law transactions of *pignus fiducia* and *hypotheca*. Hypothecation as a concept is highly connected with international trading for banks' lending. It does seem to be accepted generally that the concept of hypothecation has its origin in the Roman idea of the *pignus* and the *hypotheca*, both of which apparently were hardly different from each other in Roman legal theory.

Quite often hypothecation is regarded as an alternative name for a charge, which is an equitable interest in a secured chattel entitling the chargee to attach that chattel or the proceeds therefrom for the settlement of a debt owed to him upon default of the chargor through insolvency or otherwise.² The term lien is also used to denote hypothecations generally.³ The concept of hypothecation within the international trading arena actually encompasses and extends beyond both the charge and the possessory lien, including the equitable charges, fixed and floating charges, equitable liens, statutory hypothecations and judicial hypothecations.

Definition of the Concept -Hypothecation

The New Webster's Dictionary of the English Language International Edition⁴, defines hypothec as applicable to Roman and Scottish law to mean "a security held by a debtor but serving as a guarantee to the creditor, who will assume possession if the debt is not paid. Hypothecation also means to pledge property as security.

Black's Law Dictionary⁵ defines the concept hypothec to mean, "a mortgage given to a creditor on property to secure a debt". Hypothecation is also a mortgage of property in which the debtor was allowed to keep, but not alienate, the property. 'Hypothecation equally means 'the pledging of something as security without delivery of title or possession'.⁶

Osborn's Concise Law Dictionary⁷ defines hypothecation as 'a charge on a ship or her freight or cargo to secure moneys borrowed by the master for necessities required during the voyage. It is also a charge on property as security for the payment of a sum of money where the property remains, in the possession of the debtor'.

Basis of the Concept

Salmond⁸ explaining the character of hypothecation (which he refers to as the lien), states that this security is of its own nature a security for a debt and nothing more and it cannot survive the

¹ Sykes, E. I. and Walker, S: *The Law of Securities*. The Law Book Co; Australia, 5th Edn., 1993, pp. 14-15.

² Omotola, J. A. *The Law of Secured Credit*. Evans Brother (Nig. Publishers) Ltd; Ibadan, 2006, P.113.

³ *Ibid*

⁴ Lexicon International publishers Guild Group, New York, 2004,p.477

⁵ Thompson West Group, USA, 8th Edition, 2004, p. 759

⁶ *Ibid*

⁷ Sweet & Maxwell, London, 8th Edn, 1993, p. 169

⁸ Fitzgerald, P. J. *Salmond on Jurisprudence*. Sweet and Maxwell, London, 12th Ed., 1966, pp. 429-430

debt. It is merely the shadow so to speak, cast by the debt upon the property of the debtor. He in appropriating the term 'lien' to cover all other forms of hypothecation restates as follows⁹:

The word lien has not succeeded in attaining any fixed applications as a technical term of English law. Its use is capricious and uncertain and we are at liberty therefore to appropriate it for the purpose mentioned in the text, i.e. to include all forms of security except mortgages.

Salmond proceeds further to define a lien as a right, which is in its own nature a security for a debt and nothing more – for example, a right to retain possession of chattel until payment, a right to distrain for rent or to receive payment out of a certain fund. He contrasts this with a mortgage, which he says is a right, which is in its own nature an independent or principal right.

Goode¹⁰ is of the view that this wide generalization of the use of the term 'lien' could be misleading and in fact unnecessary because most references to the term 'lien' clearly allude to either a possessory lien i.e. 'a right conferred by law to detain property until money owed to the detainee has been paid or an equitable lien, which is a right conferred by operation of law to demand an order that certain property stand as security for the repayment of a debt owed to the claimant.

Thus, the justification for the concept of hypothecation is that where goods, are contained in the borrowers warehouse which cannot be sealed off to enable lender become pledgee of them or where it is impracticable for the lender to have possession of goods which may be temporarily in the custody of a third party, a pledge of such goods is impossible. In any of such circumstances highlighted, an option lies in creating a charge of those goods through a method known as hypothecation.

Hypothecation involves the passing of neither the property in the goods nor the possession of them to the lender. The goods remain in the possession of the borrower or a third party while security over them is granted by means of a letter of hypothecation. The old case of *Re Hamilton Young & Co*¹¹ illustrates the arrangements. In that case, a bank made advances to its customers who gave the bank “Letter of Lien” accompanied by bleachers receipts for the goods. The bank gave notice of the transaction to the bleachers. Upon the customer becoming bankrupt, it was held that the charge in favour of the bank was valid and therefore, the creditor had priority over the customer's assignees in bankruptcy.

For example, Salmond has stated that it is a misnomer to describe hypothecation as a 'lien'¹² and ipso facto 'letter of hypothecation' as 'letter of lien' as it is sometimes called. While both concepts share a common denominator in the sense of creating an encumbrance over the goods in question as opposed to a transfer of either a proprietary or possessory interest in them, the concepts arise under different circumstances; for, while a charge in the form of hypothecation

⁹ *Ibid*, p. 429

¹⁰ Goode, R. M. *Legal Problems of Credit and Security*. Sweet & Maxwell, London, 3rd Ed. 2003, p. 31

¹¹ (1905) 2 KB p.772.

¹² *Op.cit*, pp. 429 - 430

arises mainly by act of parties, a lien generally arises by operation of law or rules of equity from the relations between the parties.¹³ The true nature of hypothecation does not involve parting with ownership of the property at the time of creating it to be reconveyed upon repayment but rather, it is an agreement to appropriate the asset to discharge the debt. According to R. M. Goode,¹⁴ it “is merely an encumbrance, a weight hanging on the asset which travels with it into the hands of third parties, other than the bonafide purchaser for value and without notice.” Upon failure to repay the loan, the creditor appropriates the charged assets and *ipso facto*, the ownership rights of the borrower, through judicial sale or by appointing a receiver. These rights are however, postponed to that of the bonafide purchaser of the subject matter as security for value without notice of the encumbrance.¹⁵

The basis for the creation of security through the method of hypothecation is that the formality is simple in the sense that it need not be in a particular legal form and may therefore be by a letter instructing the borrower's banker to hypothecate the chattels to the borrower's indebtedness. The chattels hypothecated must be in existence at the time of transaction. Hence, hypothecation of unascertained or future goods is ineffectual since no such chattels can be appropriated upon the debtor's default.

Hypothecation, being an equitable charge, the modes of enforcement open to a creditor in respect of loan secured by hypothecation over goods is judicial sale and appointment of a receiver.¹⁶ Furthermore, a letter of hypothecation may be a convenient way of creating security over goods abroad or at sea in the custody of a bailee. Thus, with the multitude of risks facing the subject matter of hypothecation, a pledge of chattels is most favoured by creditors in the modern times. This may be in the form of taking physical possession of the chattels or constituting the only access to them, or otherwise, taking custody of the bill of lading with regards to consignment at sea.

Classification of Hypothecation

Salmond is of the view that they are various forms of hypothecation, which he describes as liens¹⁷. These include *inter alia*:

- 1) Possessory Liens – These consist of the right to retain possession of chattels or other property of the debtor, e.g. pledges of chattels, liens of wine keepers, solicitors and vendors of goods
- 2) Rights of distress or seizure, e.g. distress for rent, occupiers right to distrain cattle trespassing.
- 3) Powers of sale – These are not isolated but usually incidental to the right of possession conferred by one or the other of two preceding forms of lien.
- 4) Powers of forfeiture – these are powers vested in the creditor to destroy in his own interest some adverse right vested in the debtor, e.g. landlords right of forfeiture of the deposit paid by the tenant.

¹³ Smith, I. O. *Nigerian Law of secured Credit*. Ecowatch publications Limited, Lagos, 2006, P. 211

¹⁴ *Legal Problems of Credit and Security*. *Op.cit*; p. 14.

¹⁵ Smith; I. O. *Nigerian Law of Secure Credit op.cit*; p 22

¹⁶ *Mathews v. Gooday* (1861) 31 LJCH ch. P. 282

¹⁷ J. W. Salmond, *Op. Cit.* pp. 432 – 433

- 5) Charges consist of the right of a creditor to receive payment out of some specific fund or out of the proceeds of the realization of specific property. The fund of the property is said to be charged with the debt.

A more appropriate classification of hypothecation is to group them into possessory, contractual and equitable liens¹⁸

- i. The possessory lien. This form is like a pledge because it is based upon possession of the property affected. This law invariably implies a right in favour of the creditor to detain the property until the debts owed to him is paid. Such a lien may operate over real or personal property.
- ii. The contractual lien – This also bears a similarity to the pledge to the extent that it arises from an act of the parties rather than by implication of the law. It is different from the pledge because it does not confer a right of sale over the property but only a right to retain possession of the asset as security for debt. It does not however, constitute a transmissible interest¹⁹
- iii. The equitable lien – This form of lien is neither created by an act of the parties nor is it based purely on possession. The equitable lien, like all other liens arises by operation of law. It is not a creation of legislation as in the case of statutory liens, rather it arises by implication of law. Like the equitable charge, it is a pure hypothecation, that is, it involves no transfer of actual or potential ownership, it does not depend on possession and vests only equity; the result of this being that it is unenforceable against the bonafide purchaser for value of the legal estate without notice²⁰

The main difference between the equitable lien and the equitable charge is the mode of creation, that is while the equitable charge arises from acts of the parties, the equitable lien is implied by law from the prevailing circumstances. The equitable lien can also be distinguished from the common law possessory lien on the basis that the latter is dependent on possession while the equitable lien is not necessarily so dependent. It is also different from statutory liens, which are express creations of statutes.

Statutory Hypothecations

Statutory hypothecations are of course, creations of statute and are pure hypothecations in the sense that no dominion passes or can pass to the chargee. They are relatively common in modern legislation. Statutory hypothecation by creation seems more like liens since they arise by operation of law, but statutes usually give them more power than the usual powers of an equitable lienee. These include the power to apply to court for a judicial sale and sometimes an outright power to sell out of court by a special statutory procedure.²¹

These forms of hypothecation are common in revenue laws in respect of unpaid land taxes and rates, maritime law, etc. Other powers, while may be granted by such statutes, include power to take possession and recover the amount as if it were rent.²²

¹⁸ Omotola, J. A. *The Law of Secured Credit, Op.cit*, p. 115

¹⁹ *Ibid*

²⁰ Sykes, E and Walker, S. *Op.cit*, p. 199; Omotola, J. A. *Op.cit* p. 116

²¹ Omotola, J:A *op.cit* p. 124

²² Sykes and Walker, *op.cit*, p. 206; Omotola, J. A. *Ibid*, pp 124 - 125

Another form of statutory hypothecation is the charge by deed by way of legal mortgage provided for under the Property and Conveyancing Laws of the Western and Mid Western States of Nigeria.²³ Similar provisions exist in the English Law of Property Act, 1925.²⁴ This statutory charge is, in substance, not different from a legal mortgage as the law confers, all the rights, powers and the benefits of a legal mortgagee on the creditor.

A company's statutory lien over its own share to the extent of the unpaid portion of its called up share capital as provided for by CAMA is a further illustration of a statutory hypothecation.²⁵ The company lien on a share extends to all dividends payable on it. A unique feature of this lien is that the statute²⁶ empowers the company to sell any shares on which the company has a lien (after due notice to the registered holder).²⁷

Another form of statutory lien is statutory Maritime lien, which exists in various jurisdictions. This usually covers the wages of the master of a ship and wages of seamen generally. In summary, statutory hypothecations are of varied types and exist in our different statute books.

Judicial Hypothecations

These are securities which, even though they derive their existence ultimately from statutes, do not arise except through some judicial act.²⁸ Such securities can only come into existence by the order of the court. They have been described as judicial liens on the basis that all judicial hypothecations are essentially liens since they come into being by operation of law.²⁹

These liens are mostly created over personally, e.g. charging orders over stocks and shares or over interest in a partnership. It is also possible to have them made over real property. They are usually created mostly in favour of judgement creditors. Examples of judicial hypothecations abound and they arise every time a right exists for a party to apply to court for an order to be made charging certain assets to the repayment of some outstanding debt.

Other form of judicial hypothecation relates to the solicitors charge. The section of the act gives the court in England in which a solicitor has been employed to prosecute or defend any action, jurisdiction to declare the solicitor entitled to a charge on the property recovered or preserved through his instrumentality for his taxed costs in reference to that action.³⁰ The power of the court to issue such a charging order was upheld in the Nigerian case of *Sagoe v. The Queen*.³¹

Hypothecations have played a vital role in the realm of securities over centuries in different jurisdictions from the days of the Roman *Pignus* and *hypotheca* to the recognition of the early forms of the floating charge in cases like *Holroyd v Marshall*, *Tailby v. Official Receiver*³² the

²³ Sections 108 - 110

²⁴ S.87

²⁵ S. 139 (1) of CAMA, Cap. C 20 LFN 2004.

²⁶ S. 139 (3) *Ibid*

²⁷ Omotola, J. *op.cit* p. 125

²⁸ *Ibid*, p. 126

²⁹ *Ibid*

³⁰ Section 69 of the English Solicitor's Act 1860.

³¹ (1963) 1 ALL NLR 290.

³² (1862) 10 HLC 191

emergence of various equitable liens and charges to the recent and not so recent statutory and judicial hypothecations.³³

Hypothecations have proved to be more convenient, less cumbersome security devices compared to the traditional legal mortgage. Thus, there appears to be a dearth of authorities in our law on hypothecations till date. As a result of this lack of authorities, the Nigerian secured credit world is still largely dominated by mortgage of landed property, which does seem to have durability and enforceability through exercise of power of sale or foreclosures over other forms of security.

Omotola³⁴ in his book: *The Law of Secured Credit* has rightly opined in this direction thus:

It is, however, hard to overlook the major factor in favour of the legal mortgage, which is the fact that it puts the legal mortgagee completely in a class of his own as against other creditors, even those secured by fixed or floating charges and other equitable securities generally his interest being capable of standing against practically all others, except a prior legal interest.

Conclusion

To conclude, the concept of hypothecation is very confusing and nebulous. One wonders the rationale why the security in issue should be held by the debtor but at the same time serving as guarantee for the lender. The debtor no doubt appears to be in a more vantage position by being in possession of the property and the money at the same time. It is highly inequitable to so hold, for the mortgagee (lender) will be put in a precarious position and his security interest likely to be jeopardized anytime the mortgagor realizes he cannot redeem the debt. There should thereby be a definite legislation on this issue by the legislators. It is our considered view that the mortgagee should be allowed to retain possession of the property until the debt is fully paid by the mortgagors. In this way there will be balances on both parties to the security arrangement.

Also the true nature of hypothecation does not involve the parting with ownership of the property; rather it is an arrangement to appropriate the asset to discharge the debt. The tendency invariably is that, it is prone to deceit and misrepresentation on the part of the debtor who can easily outsmart the creditor since he is in possession of the property and the money the subject matters of the security. A sound legislation on this point is long overdue by our legislators both home and abroad as to the true and exact meaning of the concept of hypothecation.

³³ Omotola, J. A. *op.cit.* p.127

³⁴ *Ibid*