Privy Council Appeal No. 46 of 1985

Hua Chiao Commercial Bank Limited *Appellants*

v.

Chiaphua Industries Limited (formerly known as Chiap Hua Clocks and Watches Limited) *Respondents*

FROM

THE COURT OF APPEAL OF HONG KONG

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 25TH NOVEMBER 1986

Present at the Hearing:

LORD BRIDGE OF HARWICH
LORD BRANDON OF OAKBROOK
LORD OLIVER OF AYLMERTON
LORD GOFF OF CHIEVELEY
SIR IVOR RICHARDSON

*[Delivered by **Lord Oliver of Aylmerton**]*

By a lease dated 29th March 1979 Fook Kin Enterprises Company Limited ("Fook Kin") as landlord granted to the present respondent, Chiaphua Industries Limited (formerly known as Chiap Hua Clocks and Watches Limited), ("Chiaphua") as tenant a lease of certain premises in Hong Kong for a term of five years from 1st February 1979. It was provided in the lease that the expression "the landlord" "where the context so admits shall include its executors administrators and assigns" and that the expression "the tenant" "where the context so admits shall include its executors administrators and assigns". The crucial provision of the lease for present purposes is clause 4(h). It provides:-

> "The Tenant shall pay to the Landlord a sum of DOLLARS TWO HUNDRED SEVENTY SEVEN THOUSAND EIGHT HUNDRED NINETY SIX AND CENTS EIGHTY ($277,896.80) as a security deposit on or before the signing of this Lease. The deposit shall bear no interest and if there shall be no breach of any of the terms and conditions on the part of the Tenant herein contained, the deposit shall be returned to the Tenant at the expiration of the term of

this Lease or sooner determination of the same but shall if otherwise be absolutely forfeited to the Landlord as liquidated damages without prejudice to the Landlord's right of action against the Tenant for any of its breaches thereof."

On 5th February 1982 Fook Kin mortgaged its interest in the reversion to Hua Chiao Commercial Bank Limited ("Hua Chiao") by way of assignment with provision for re-assignment on repayment of capital and interest. Nothing was expressed in relation to the security deposit. Following default by Fook Kin under the mortgage, on 15th January 1983 Hua Chiao took possession of the mortgaged property and took receipt of the rents and profits. Fook Kin subsequently went into liquidation and Hua Chiao remained in possession of the property.

The security deposit payable under clause 4(h) - which was equivalent to two months rent under the lease - had been paid by Chiaphua to Fook Kin at the commencement of the lease. On 31st January 1984 the lease expired. Chiaphua was not then in breach of any of the terms and conditions of the lease nor was it suggested that it had been in such breach at any time before or after the assignment of the reversion to Hua Chiao.

Chiaphua issued an originating summons in the High Court at Hong Kong seeking a declaration that Hua Chiao was liable to return the deposit to Chiaphua. On 19th September 1984 Master Boa dismissed the claim and an appeal against that decision was dimissed by Mayo J. on 14th January 1985. However on further appeal the Court of Appeal in a judgment delivered on 18th April 1985 allowed the appeal and granted the declaration sought. It held that the obligation to return the security was one which touched and concerned the land and accordingly was an obligation the burden of which passed to and was binding on Hua Chiao. Hua Chiao now appeals.

There is a considerable measure of common ground between the parties. It is not in dispute that the appellants constitute, by assignment, "the landlord" for the purposes of the lease. Equally it is not in dispute that the test of whether the original landlord's covenant to return the amount of the deposit is enforceable against a successor in title is the same as it would be if the lease had been a lease of land in England, that is to say, whether the covenant is one "entered into by a lessor with reference to the subject-matter of the lease" or, to use the common law terminology, whether it is a covenant which "touches and concerns the land". Nor is there any disagreement about the formulation of the test for determining whether any given covenant

touches or concerns the land. Their Lordships have been referred to and are content to adopt the following passage from the 13th Edition of Cheshire and Burn's Modern Real Property at pages 430 and 431:-

> "If the covenant has direct reference to the land, if it lays down something which is to be done or is not to be done upon the land, or, and perhaps this is the clearest way of describing the test, if it affects the landlord in his normal capacity as landlord or the tenant in his normal capacity as tenant, it may be said to touch and concern the land.
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> Lord Russell C.J. said:-
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> > 'The true principle is that no covenant or condition which affects merely the person, and which does not affect the nature, quality, or value of the thing demised or the mode of using or enjoying the thing demised, runs with the land;' [*Horsley Estate Ltd. v. Steiger* [1899] 2 Q.B. 79, 89]
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> and Bayley J. at an earlier date asserted the same principle:-
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> > 'In order to bind the assignee the covenant must either affect the land itself during the term, such as those which regard the mode of occupation, or it must be such as *per se*, and not merely from collateral circumstances, affects the value of the land at the end of the term.' [*Mayor of Congleton v. Pattison* (1808) 10 East. 130 at p. 138]
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> If a simple test is desired for ascertaining into which category a covenant falls, it is suggested that the proper inquiry should be whether the covenant affects either the landlord *qua* landlord or the tenant *qua* tenant. A covenant may very well have reference to the land, but, unless it is reasonably incidental to the relation of landlord and tenant, it cannot be said to touch and concern the land so as to be capable of running therewith or with the reversion."

The two points upon which the parties divide are (a) whether as a matter purely of the construction of the clause it can be said to contemplate a payment by or to anyone other than the two original parties to the lease and (b) whether, assuming that the covenant is apt in its terms to impose an obligation between persons other than the two original parties, the obligation is one which, whatever the parties may have intended, touches and concerns the land so as to impose, through privity of estate, a financial obligation on a successor in title to "return" that which he has never had.

As regards the question of construction, the arguments are finely balanced. On any analysis the clause is, to say the least, infelicitously drawn. It seems tolerably clear that the parties can never have addressed themselves here specifically to the event of an assignment either of the reversion or of the lease even though clause 5 of the lease clearly shows that they entertained the possibility of the term being assigned. On the one hand, it can be said that the initial references to the tenant and the landlord can refer only to the original parties and that there is no necessary context for reading the subsequent references in the clause as having any wider connotation, particularly having regard to the use of the word "return" which hardly seems appropriate to a payment by a person who has never received money to a person who has never paid it. On the other hand, where, as here, the reversion changes hands, there seems little sense, if the covenant is a purely personal one, in postponing repayment until the end of the lease. Moreover, as Mr. Sumption has forcefully pointed out, the reference to the "return" being without prejudice to the landlord's right of action appears to contemplate that the "landlord" obliged to return the payment will be the same person as the "landlord" having then the right of action for damages for breach of covenant. If it were otherwise, then the original tenant, if in breach of covenant, would be liable to an action for damages at the suit of the new landlord without any countervailing obligation on the new landlord to give credit for the deposit forfeited to the original landlord.

It is indeed doubtful whether it is possible to apply any totally rational construction to the clause without a wholesale implication of terms which the parties have not thought fit themselves to express. That in itself is not an easy exercise although it is not one from which their Lordships would or could shrink if it were necessary to make the attempt. But it is not, in the final analysis, necessary for their Lordships to express any concluded view on the proper construction of the clause, because there remains in any event the critical question of whether, even assuming that, as a matter of construction of the clause, there can be deduced the intention by the original parties that the benefit and burden of the landlord's obligation for payment should pass without express assignment or novation to and against successors in title, that is a result which, having regard to the nature and purpose of the obligation, is capable of achievement. And as regards this question, their Lordships have found themselves unable to agree with the decision reached by the Court of Appeal in Hong Kong.

In the High Court, Mayo J., in holding that the landlord's obligation to "return" the deposit was not one which ran with the reversion, relied upon the decision of Uthwatt J., as he then was, in *Re Hunter's Lease* [1942] Ch. 124 and upon a decision of Grant J. in the Ontario High Court (*Re Dollar Land Corporation Limited v. Solomon* (1963) 39 D.L.R. (2nd Ed.) 221) where the relevant facts were substantially indistinguishable from those in the instant case. In the former, the original lessor had covenanted to pay to the lessee a sum of £500 upon the determination of the lease, but subject to a proviso that if he was unwilling to pay the covenanted sum the lessee would be entitled to remain in occupation and to call for a new lease for five years subject to the same conditions as to determination and as to payment of £500. The question raised by the originating summons was whether, the reversion having changed hands, the obligation to pay £500 on the determination of the lease was one which bound a transferee of the reversion. Although it was conceded that a bare covenant by the lessor to pay a sum of money on the determination of the term clearly did not touch and concern the land, it was argued that the obligation in that case was one which was part of an arrangement governing the continued occupation of the premises by the lessee and therefore passed to the transferee of the reversion. Uthwatt J. rejected that argument, quoting from the judgment of Channell B. in *Thomas v. Hayward* (1869) L.R. 4 Ex. 311:-

> "A covenant runs with the land only when it touches, that is, when its operation directly, and not merely collaterally, affects the thing demised."

In the Canadian authority relied on by Mayo J. the clause in question provided (so far as material) that the lease was executed by the lessor upon condition that the lessee would forthwith deposit with the lessor a sum of $165 "in order to assure the performance by the lessee of all terms, conditions and provisions herein contained". It further provided that "under no condition shall the lessee be entitled to ask for or demand the return or a rebate of any part or all of the said sum of $165 until the expiration of the period provided for in this lease ... and then only if the lessee has fulfilled all the terms, conditions and provisions herein contained ...". Grant J., after an extensive review of the English authorities, concluded thus:-

> "It would appear from the cases above quoted that such an arrangement as is set forth in the guarantee clause of the lease ... is a personal obligation only between the immediate landlord and his lessee. It is not such an arrangement as deals with the subject-matter of the lease. As Dollar Land received no part of the $165 paid by

> the tenant Solomon, I do not find any obligation on its part to now repay the same to Solomon."

The Court of Appeal in Hong Kong declined to follow the Canadian authority, observing that although the cases cited to Grant J. did support the general proposition that a covenant by a party to a lease to pay a sum of money at the end of the term was personal to the original parties, he did not have (and nor did Mayo J. in the High Court) the benefit of the citation of the two English cases which put a gloss upon that general proposition. The first was *Mansel v. Norton* (1883) 22 Ch. D. 769 a decision of the Court of Appeal where the question which fell to be decided was whether the responsibility for the performance of a covenant in the lease of a farm for the purchase by the lessor of the lessee's tenant right at valuation on the expiration of the term fell upon the landlord's estate or upon the devisee under his will who had entered into possession. It was held that the landlord's covenant was one which passed with the reversion and that the burden therefore fell upon the devisee in possession. The second case relied upon by the Court of Appeal in the instant case was a decision of Wright J. in *Lord Howard de Walden v. Barber* (1903) 19 T.L.R. 183 which was concerned with a tenant's covenant not to do or suffer anything which should be, or tend, to the annoyance, nuisance or damage of the person or persons for the time being entitled in reversion. The lease contained a specific provision that if the premises should at any time during the term be used as a brothel or disorderly house the tenant should pay to the landlord a sum of £800 by way of liquidated damages. The question in issue was whether an assignee of the term who had permitted the premises to be used as a brothel was liable to pay the sum of £800. The judgment is reported shortly and only in *oratio obliqua*. Wright J. observed that:-

> "It was a strong thing to hold that a covenant to pay damages could run with the land. It seemed to him that the only way to regard it was that the covenant was inserted for the express purpose of binding the assignee. It was not a separate provision, but an annex to the general covenant. If it was treated as a buttress to the general covenant there was no objection to treating it as running with the land ...."

There is, of course, no doubt that the mere fact that a covenant, whether on the part of the landlord or of a tenant, involves an obligation to pay a liquidated sum of money does not of itself demonstrate that the covenant is not one which touches and concerns the land but, with respect to the Court of Appeal, their Lordships do not find

either of these two cases of great assistance in the solution of the question raised by this appeal. The covenant in *Mansel v. Norton* was, as both Jessel MR. and Lindley LJ. observed, a covenant to purchase the tenant-right or cultivation. In his judgment Jessel MR. said:-

> "Before the present state of agricultural depression a new tenant could always be found who came in and paid the outgoing tenant. The landlord was not called upon to pay. The landlord, however, was the person liable to the outgoing tenant, and in the view of the law he paid the outgoing tenant and received the amount back from the incoming tenant".

The liability, he observed, was "a liability in respect of the cultivation of the land". As such it was plainly a covenant which directly affected the value and quality of the land. Similarly, in *Lord Howard de Walden v. Barber*, the liability to pay damages for breach of the covenant not to cause damage to the reversion was clearly and on any analysis a covenant which touched and concerned the land. The covenant to pay a liquidated sum for a breach of a particular nature was no more than the quantification of the damage and was, quoad that particular type of breach, not so much a buttress for the covenant but part and parcel of the covenant itself.

The respondents argue, however, that inasmuch as the tenant's obligation to pay over the deposit on the execution of the lease was an obligation to secure the performance of covenants which touched and concerned the land, it was an obligation inextricably associated with covenants whose benefit and burden would pass with the reversion in the lease respectively. The landlord's obligation to repay if those covenants are observed is, it is argued, inseparable from that associated obligation and must therefore possess the same characteristics as the covenants whose performance is secured by the associated obligation. To put it another way the obligation to deposit is an obligation of the tenant assumed by him *qua* tenant and it follows that the correlative obligation of the landlord is an obligation assumed by him *qua* landlord. This argument is reflected in the judgment of McMullin V-P. in the Court of Appeal, who observed:-

> "The plain fact is that the provisions of clause 4(h) are so clearly intended to encourage compliance with the very many covenants enjoining the lessee to make proper use of the land and not to cause a diminution in its value that it would be wholly unrealistic to regard it as being otherwise than inextricably bound up with those undertakings generally."

That the original tenant's obligation to make the deposit is "bound up" with his obligation to perform the tenant's covenant in the lease is undeniable, but the former is, of course, a once-for-all contractual obligation between the original parties as regards which no question of transfer with the term or with the reversion can arise. The sum deposited is to be paid on or before the execution of the lease. What this appeal is concerned with, however, is only the landlord's obligation to repay once the lease has expired without breach of covenant, there being neither any obligation on the original landlord to pay over the amount of the deposit to an assignee of the reversion nor any obligation on the original tenant to assign to an assignee of the term his contractual right to receive back the amount of the deposit when and if the condition for its repayment is fulfilled. It is bound up with the tenant's covenant only, as it were, at one remove, as being an obligation correlative to a contractual obligation which is itself connected with the performance of covenants touching and concerning the land. The expression "inextricably bound" appears to derive from the speech of Lord Atkin in *Moss Empires Limited v. Olympia (Liverpool) Limited* [1939] A.C. 544, a case strongly relied upon by the respondents. The question in that case arose out of a lease which contained a series of repairing and decorating covenants on the part of the tenant numbered (iv) to (viii) inclusive. The covenant numbered (vii) obliged the tenant in each year of the term to expend at least £500 upon the performance of the covenants to repair and decorate for which receipts were to be produced to the lessor, any shortfall in any year in the amount expended to be paid to the lessor and any excess in expenditure over the amount of £500 in any year to be treated *pro tanto* as a satisfaction of the liability for future years. An assignee of the lease having failed to expend the full sum of £500 in certain years, the question arose whether the obligation was one which bound the assignee as one touching and concerning the land or whether it was merely a collateral covenant binding only as between the original parties. Lord Atkin at page 551 observed:-

> "... this is not a bare obligation to pay money which does not touch the thing demised. On the contrary, the performance of the repairing covenants and the obligations under clause vii are so inextricably bound together that it would be impossible to sever clause vii, and treat it as a collateral promise to pay money. The relevant clauses read as a whole provide a scheme whereby if things work smoothly the obligation of the tenant over the term is limited to £500 a year, less than one-sixth of the total rent, while the lessor is provided with sums which, if

> he chooses, he may apply towards meeting the obligation which he has assumed of performing structural repairs. In my opinion the clause in question closely touches the thing demised, and runs with the land."

Similarly Lord Porter at page 560 said:-

> "This is not a bare or mere covenant to pay £500 or even to pay the difference between the sum spent and proved and £500. It is part of a number of covenants whereby the mutual obligations of landlord and tenant in repairing and redecorating the premises are fulfilled and is inextricably bound up with them."

On the facts of that case the decision is scarcely a surprising one, for the obligation was to expend not less than the stipulated sum upon the preservation of the estate in the proper performance of the repairing covenants in the lease, an obligation clearly affecting the value of the lessor's estate and so directly touching and concerning the thing demised. That was, however, a very different case from the present and their Lordships are not persuaded that it is, or was ever intended to be, authority for the proposition that every covenant which is related, however obliquely, to some other obligation which touches and concerns the land necessarily takes on from that very relationship, the same character as regards transmissibility to or against successors in title. To say that the obligation to "return" the amount of the deposit is "inextricably bound up with" covenants which touch and concern the land in the sense in which the expression was used by McMullin V-P. in the instant case - i.e. that, in order to determine whether or not the obligation to pay could have arisen against anyone, it would be necessary to survey the other covenants - does not, in their Lordships' view, answer the critical question of whether it itself touches and concerns the land. It certainly does not *per se* affect the nature quality or value of the land either during or at the end of the term. It does not *per se* affect the mode of using or enjoying that which is demised. And to ask whether it affects the landlord *qua* landlord or the tenant *qua* tenant is an exercise which begs the question. It does so only if it runs with the reversion or with the land respectively. There is not, on any conceivable construction of the clause, anything which either divests the original tenant of his contractual right to receive back after assignment the deposit which he has paid or which entitles an assignee from him to claim the benefit of the sum to the exclusion of his assignor; and, plainly, the money cannot be repaid more than once. Equally, there is not on any conceivable construction anything in the clause which entitles the assignee of

the reversion to take over from his assignor the benefit of the sum deposited or which obliges the assignee, in enforcing the covenants against the tenant for the time being, to give credit for money which he himself has never received and to which he has no claim. Whilst it is true that the deposit is paid to the original payee because it is security for the performance of contractual obligations assumed throughout the term by the payer and because the payee is the party with whom the contract is entered into, it is, in their Lordships' view, more realistic to regard the obligation as one entered into with the landlord *qua* payee rather than *qua* landlord. By demanding and receiving this security, he assumes the obligation of any mortgagee to repay on the stipulated condition and that obligation remains, as between himself and the original payer, throughout the period of the lease, even though neither party may, when the condition is fulfilled, have any further interest in the land demised. The nature of the obligation is simply that of an obligation to repay money which has been received and it is neither necessary nor logical, simply because the conditions of repayment relate to the performance of covenants in a lease, that the transfer of the reversion should create in the transferee an additional and co-extensive obligation to pay money which he has never received and in which he never had any interest or that the assignment of the term should vest in the assignee the right to receive a sum which he has never paid.

Their Lordships consider that the case of *Re Dollar Land Corporation v. Solomon* was rightly decided. In all material respects it is indistinguishable from the instant case. They will accordingly humbly advise Her Majesty that the appeal should be allowed and the order of Mayo J. in the High Court dismissing the respondents' action with costs restored and that the respondents ought to pay the appellants' costs of the proceedings in the Court of Appeal. The respondents must pay the appellants' costs before their Lordships' Board.