

CONSULTATION ON AMENDMENTS TO THE LAND TITLES ORDINANCE

Rectification and Indemnity Provisions

PURPOSE

This paper seeks views on the proposed amendments to clarify how the arrangements for rectification and indemnity will work in practice and the proposed modification to the mandatory rectification rule.

BACKGROUND

2. A basic principle of title registration is that the title register provides an accurate statement of the title to a particular property that can be relied on by anyone dealing with that property. There is a risk that the land titles register can become inaccurate, whether due to deliberate fraud, a void instrument or mistake or omission.

3. To prevent injustice arising from an inaccuracy in the register, procedures are needed to allow for the register to be corrected. Using these procedures is called ‘rectification’.

4. There is also a risk that a person who has relied on the register may suffer loss due to an inaccuracy. If it is not possible to prevent or recompense for the loss by rectifying the register then financial compensation, called ‘indemnity’, may be paid. Where the inaccuracy is due to an error by a public officer in compiling or maintaining the register, the Land Registry (LR) will be responsible for paying indemnity and the amount to be paid will be the full extent of the loss suffered. In case an inaccuracy is due to fraud, indemnity for the loss suffered as a result of loss of ownership will be paid from a special fund built up from a levy on applications for registration. The Financial Secretary may set a limit (commonly called ‘the cap’) on the amount of indemnity to be paid in such cases.

5. During deliberation on the Land Titles Bill in 2003 it was argued that, because of the intended cap on indemnity in fraud cases, there was a risk that under the new system an owner whose name had been removed from the register by fraud would not be given full value compensation for his loss if the Court did not make a rectification order in his favour and the value of the property lost exceeded the amount of indemnity allowed by the cap. The Court might refuse to rectify if, after the fraud, a new purchaser, unaware of the fraud, had acquired and taken possession of the property in question.

6. Under the current common law system, in the circumstances set out in paragraph 5 an innocent purchaser would be required to give up the property without compensation – unless able to make a successful claim for recovery against the fraudster – while the former owner would recover the property.

7. The intended cap amount of HK\$30 million exceeds the value of 99% of all properties in Hong Kong. The likelihood of such cases as identified in paragraph 5 arising is low. Nonetheless, to address the objection to there being *any* risk of a former owner being left worse off (in money terms) under the new system of title registration than under the existing system, it was agreed to constrain the Court's powers of rectification in fraud cases. The constraint introduced was to require the Court to make a rectification order in favour of the former owner in any fraud case where it was found that the former owner was not a party to the fraud and did not by act or lack of proper care substantially contribute to the fraud. This requirement has been called the 'mandatory rectification rule'.

8. The Land Titles Ordinance (Cap. 585) (LTO) was passed in July 2004 on condition that a comprehensive review was carried out before the Administration sought to bring the new system into operation. The rectification and indemnity provisions enacted in 2004 have been examined as part of that review. The aim of this examination has been to assess whether they are sufficiently clear and consistent to work well in practice and whether the general effect will be conducive to the successful introduction of title registration into Hong Kong. After the examination it has been concluded that –

- (a) various provisions need to be clarified and some new provisions added to remove uncertainty and reduce the risk of disputes that may slow down the resolution of claims for indemnity and add to costs (see paragraphs 9 to 18 below for details); and
- (b) the mandatory rectification rule may have the unintended effect of reducing confidence in the title register and reducing the effectiveness of the new scheme in improving the efficiency with which conveyancing can be conducted. Opportunity should therefore be taken to reconsider whether the rule should be retained before the LTO is brought into operation. Paragraphs 19 to 28 below set out why the rule raises concern and describe modifications that would address these identified problems.

Points of Clarification

Handling of Land Registrar's costs

9. The review has found that there are two areas of uncertainty with respect to the handling of costs incurred by the Land Registrar (the Registrar) or awarded against the Registrar during rectification proceedings. The LTO gives no direction to the Court as to how the Registrar's own costs are to be dealt with, nor is it clear whether or not costs awarded against the Registrar in rectification proceedings are to be included within the indemnity payment that may be subject to the cap.

10. It is intended to add a provision to specify that the Registrar's costs in rectification proceedings are to be met by the indemnity fund unless otherwise ordered by the Court. This will remove uncertainty on the source of payment and prevent the possibility of the Registrar having to meet the costs himself simply because the Court had not made any order on the point in a particular case. It is considered appropriate to meet the Registrar's costs out of the indemnity fund since such costs would be incurred in the course of the Registrar exercising his duty to ensure that the fund is safeguarded from improper claims.

11. The LTO specifies that costs awarded against the Registrar are to be paid from the indemnity fund but is silent as to whether they come within the cap on the amount of money that may be paid as indemnity in a fraud case. It is intended to add clarification that the cap does not apply to costs awarded against the Registrar. This will be consistent with the intention that the indemnity should be based on the value of the interest that has been lost. Costs are not a part of this.

12. It is also intended to add a provision that the Registrar has the right to attend taxation hearings held by the Court to determine the amount of costs. His attendance at taxation hearings will allow the interests of the indemnity fund to be represented, providing a reasonable safeguard against the award of unreasonable costs.

Indemnity applications and costs

13. The review has noted that under section 85 of the LTO, the amount of indemnity that may be paid is limited to the 'value of the interest' held by the person suffering the loss. This is correct in fraud cases but would have the unintended effect of limiting the liability of Government for losses caused due to mistake or omission on the part of public officers. Section 85 will be amended to make clear that Government's liability arising from its own mistake or omission extends to all actual losses suffered.

14. The review has found some ambiguity in identification of the persons who may claim indemnity. It is intended to make clarification that in fraud cases, the persons who may be eligible to claim indemnity include both owners affected by rectification and other parties who suffer loss as a result of displacement of an owner by a rectification order or refusal to grant a rectification order. In mistake or omission cases any person who suffers actual loss may claim.

15. Section 84(1) uses the term “which affects ownership” to define cases in which indemnity may be paid in fraud cases. The review has noted some uncertainty over the meaning of this term. It is intended to replace it with “which results in the loss of ownership”. The proposed modification will make it clear that the indemnity fund will not be liable for claims in cases where there has not been any loss of ownership due to fraud.

16. The LTO states that the amount of indemnity to be paid is to be calculated on the basis of the value of the interest on the date on which the entry in the register that caused the loss was made. The review has found that this formula may not be applicable in various circumstances. In omission cases there is no entry that can be dated. The appropriate date for calculating loss should be the date of application for an entry that was subsequently omitted. In fraud cases where the person who suffers loss is a purchaser subsequent to the fraud, the appropriate date will be the date of the rectification order removing the purchaser from the register. It is intended to amend section 85 to allow for different dates for determining loss to be used in these circumstances.

17. The review has noted that the LTO does not specify how the indemnity is to be apportioned if there are multiple claimants arising from a fraud case and the total value of the claims exceeds the amount that may be paid due to the cap. To avoid disputes and the delay and cost of any litigation to resolve such questions should any case arise, it is intended to provide a rule for determining the apportionment in such circumstances. The rule to be proposed is that each claimant would be paid from the indemnity amount in proportion to the value of his loss. To give an illustration as to how this would work, let us assume a case in which the total claim amounted to \$40 million, exceeding the cap amount of \$30 million. Of the \$40 million claim, \$32 million is by the displaced owner and there are two further claims of \$4 million each by other parties who suffer loss because the owner is displaced. The displaced owner’s share of the total claim would be 80%, while the other two parties’ shares would be 10% each. The outcome under the proposed rule is that the displaced owner will be paid 80% of \$30 million, or \$24 million, while the other two parties each get 10% of \$30 million, i.e. \$3 million.

18. The LTO requires an interested party to make an application to the Registrar for the payment of indemnity. The review notes that no provision has been made for the Registrar's costs in processing the application are to be settled. It is intended to add clarification that the Registrar's costs of processing the applications will be met from the indemnity fund. It is also proposed to make clear that the applicant's costs for making such application to the Registrar are not payable unless awarded by the Court and such costs will also be met from the indemnity fund.

Mandatory Rectification

19. Paragraphs 5 to 7 above give the background as to why the mandatory rectification rule was introduced. The review has included a careful analysis of how the rule would be likely to work in practice. The relevant provisions of the enacted LTO are –

Section 82(1), which allows the Court to order rectification of the register by directing that an entry in the register be removed, altered or added if it is satisfied that the entry was obtained, made or omitted by or as a result of fraud.

Section 82(3), which requires the Court to make an order of rectification in favour of 'a former registered owner' (if innocent) if he lost his title by or as a result of fraud, irrespective of whoever is currently the registered owner. This is the 'mandatory rectification' provision.

Section 84(1), which states that a person suffering loss by reason of an entry in the register or omitted from the register that has been obtained, made or omitted as a result of fraud (as determined at the end of rectification proceedings under section 82) which has affected the ownership of registered land shall be indemnified by Government in respect of that loss.

Section 85(1)(a), which specifies the amount of the indemnity in fraud cases. Where the value of the interest in the registered land that has been lost on the date on which the entry was obtained, made or omitted is less than the cap, then the amount to be paid is the value of the interest lost. Where the value of the interest in the registered land that has been lost is higher than the designated cap then the cap amount is to be paid.

How would the enacted law work

20. To help show how the present LTO would work in cases where fraud happened after the land affected had been brought under the LTO, the following diagram represents a series of sales (denoted by →) of a property between a number of successive owners –

Owner:	A	→	B	→	C	→	D	→	E
Encumbrances:	A*		B*		C*		D*		E*

21. If there were a fraudulent transfer to C (C being a fraudster) in the diagram above, discovered when E had become the owner then –

- (a) B, the innocent former owner, would be restored to the register as owner, by operation of section 82(3);
- (b) B*, the encumbrances to which B was subject, may also be restored if still subsisting;
- (c) E, an innocent registered owner who acquired the property from D, would be removed from the register but would be eligible for indemnity. D, an innocent purchaser from C, is not involved in the rectification proceedings having sold his interest in the property;
- (d) encumbrances E* that are affected by the removal of E from the ownership register may arguably also give rise to entitlement to indemnity if loss is suffered as a result (the amendment proposed in paragraph 14 above will clarify that they may do so); and
- (e) if C had procured his registration as owner by fraud and had not sold the property on to D, C will be removed from the register and B restored. No indemnity to C arises.

22. The effect of sections 82(3), 84 and 85(1)(a) taken together is that –

- (a) the position of the innocent former owner under existing common law is preserved. He will recover the property; and
- (b) any registered owner risks loss of the property at any time during their ownership if a former owner is able to establish a claim that he had lost his title due to fraud and his right of action is not time barred. If the fraud occurs after the land is brought under the LTO and the current registered owner is an innocent party then he will be

eligible for indemnity. Although the indemnity may be subject to the cap this is still a better position for him than under common law. At present he will get nothing unless able to trace and undertake a successful action for recovery against the fraudster or other person responsible.

Why might the enacted law cause problems for the operation of the title registration system?

23. The following issues have been identified with respect to the current provisions on rectification –

- (a) no purchaser of registered property is protected by the title register against the effect of fraud prior to the transaction in which he is involved. This may undermine the security and ease of conveyancing that the LTO aims to achieve. A prudent purchaser will want to go behind the title register to investigate previous transactions in order to obtain greater assurance that he will not be at risk. This would amount to a reversion to the old system of investigation of title as under the current deeds registration system;
- (b) there may be cases in which, before a claim for rectification is made, the lot or lots affected have been resumed or surrendered to Government. Rectification to a former owner is a practical impossibility in such circumstances;
- (c) there may be cases in which, after the fraud, the property is divided up and sold on to several new owners or developed and undivided shares sold on to multiple new owners. Displacing and compensating multiple innocent parties in such cases is likely to cause greater disruption and incur greater cost to the indemnity fund than giving indemnity to the former owner; and
- (d) as drafted, the mandatory rectification rule applies to new land as well as to converted land, but there is no necessity for this as new land is never subject to the prior common law position and there is no question of a former owner of new land being put in a worse position than he previously enjoyed.

24. The review noted that the requirement for mandatory rectification to an innocent former owner was introduced as a committee stage amendment to LTO in 2004 in response to –

- (a) strong opinion that there should be certainty in the operation of the rectification provisions, rather than leaving wide discretion to the Court; and
- (b) recognition that, due to the effect of the cap, unless rectification was made in favour of the former owner a former owner might find himself worse off under the new system than under existing law.

25. The review considered that paragraph 24(b) above should not be a material consideration when dealing with new land. Furthermore, given the other identified difficulties that the mandatory rectification rule could cause, it was sensible to consider whether there was any better approach that could be developed for inclusion in the Land Titles (Amendment) Bill that is to be introduced before the LTO comes into effect. It was considered that any alternatives should try to keep as close as possible to the framework agreed in 2004. Mandatory rectification should be retained as far as possible and clear rules laid down for the Court.

The suggested modification to the rectification rule

26. Following from the general approach outlined above, the specific suggestions developed for modifying the rectification rule so as to address the identified problems are –

- (a) the mandatory rectification rule in section 82(3) is to be maintained but made subject to specific exceptions;
- (b) the exceptions proposed are where–
 - (i) the current registered owner who is in possession of the property is not the first person to have been registered as owner since the fraud. He is a bona fide purchaser for value or a person deriving title from such bona fide purchaser; or
 - (ii) there has been resumption or surrender of the property to Government since the fraud; or
 - (iii) the property has been divided up and sold or agreements for sale and purchase have been entered into for sale of the property to new bona fide owners resulting in multiple ownership of the property; and
- (c) an innocent former owner not restored to the title register due to the operation of any of the exceptions will be eligible for indemnity.

27. To illustrate the effects that these proposals would have, consider the same diagram previously used in paragraph 20 and the new consequences that would arise from the modified rules –

Owner: A → B → C → D → E
Encumbrances: A* B* C* D* E*

- (a) The innocent former owner, B, will recover from D (unless the property has been divided and D represents the more than one bona fide new owner of the property);
- (b) The former owner B will not recover from E, a second bona fide owner after the fraud who is in possession of the property;
- (c) In any event, B will not recover the property if it has been resumed or surrendered to Government;
- (d) If B does not recover the property he will be eligible for an indemnity subject to the cap; and
- (e) If B recovers from D, then as an innocent party D will be eligible for an indemnity that will be subject to the cap.

28. The proposal that a bona fide purchaser or his successor to title who is not the first bona fide party to deal with the property after a fraud should enjoy indefeasible title will bring what is called the doctrine of *deferred indefeasibility* into the LTO. This is a doctrine that has been applied in a number of jurisdictions that have title registration systems to achieve a balance among the need for the register to give security if it is to achieve the intended purpose of easing transactions, the reasonable claims of defrauded owners and the objective of keeping incentive for purchasers to exercise care. By giving security to the second bona fide owner registered after a fraud, owners are given security against historical matters which they have no practical means to investigate. But, a prospective owner does have to exercise care in the transaction by which they themselves become registered as owners since, if they have dealt with a fraudster, they are not given security against rectification in favour of the true owner affected by the fraud.

Change to Indemnity Provisions

29. If the modifications suggested in paragraph 26 were to be adopted, some change would also be needed with respect to the handling of cases where land had been converted to the title register and a fraud that had been committed

before conversion was subsequently discovered. The LTO currently contains a provision (section 84(4)(c)) which bars the payment of indemnity in any case where the fraud took place before the date of conversion. The intention is to protect the indemnity fund from having to compensate for conditions that existed before conversion of which Government could have had no knowledge and could not control. If the concept of deferred indefeasibility is brought into the LTO then the possibility will be created that a former owner may be barred both from recovering the property and, if the fraud that removed him from the register occurred before conversion, he would also be barred from any indemnity. Conversely, if the mandatory rectification rule were to be left in place, any post conversion purchaser could find themselves facing loss of the property without any indemnity due to a the pre-conversion fraud, even though they would have paid the levy for the indemnity fund upon application for registration as owner. In either circumstance it would not appear just to bar the payment of indemnity.

VIEWS SOUGHT

30. The Administration is inviting views on –

- (a) whether all of the modifications to the mandatory rectification rule proposed in paragraph 26 should be adopted; or
- (b) whether only the modifications to address the issues set out in paragraph 23(b) (where land has been surrendered or resumed subsequent to a fraud) and 23(d) (deferred indefeasibility to be the rule for new land) should be adopted; and
- (c) the proposed clarifications to various provisions set out in paragraphs 9 to 18.

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