

# How to ensure creditor protection in Cyprus

## This guide outlines the many ways in which under Cypriot law businesses can protect their interests in their commercial dealings

Any creditor needs to ensure that he will receive payment for the sale of his goods or services, or that his loan will be repaid.

The creditor often relies on the right to bring legal proceedings:

- Which will result in a judgment debt that can ultimately be enforced by seizing and, if necessary, selling, any of the debtor's assets that the creditor can lay his hands on; and/or
- For bankruptcy (if an individual) or a petition for a winding-up (if a company); failure to pay a debt after due demand is an act of bankruptcy or a ground for winding up. But, if the reason for such non-payment is a genuine dispute over the amount of the debt, or if there is counter-claim of some sort, eg a breach of contract on the part of the creditor, the debtor may successfully resist the proceedings/petition, and the court may regard such proceedings/petition an abuse entitling the debtor to an award of his cost in the action against the creditor. However, placing the debtor in bankruptcy or liquidation is a false triumph. Other than the fact that this a time consuming process, all creditors are invited to share in the spoils, which in practice means that a 100 per cent recovery by the creditors is rarely achieved.

The aim therefore is to place the creditor in a position to recover the debt quickly without resorting to bankruptcy or winding up proceedings. Where such proceedings are inevitable, the aim is to place the creditor in a position to recover the debt in full even if the debtor is unable to meet all of his liabilities. The creditor must accordingly make use of the means available either at law or under contract to ensure both payment and priority.

### Guarantees

If the debtor does not appear to the creditors to be creditworthy, the creditor may require the debtor to find a guarantor who is financially able. The best guarantor is invariably a bank, and such guarantees can be obtained by commercial customers for a fee.

Guarantees are often obtained by holding companies for the liabilities of their subsidiaries and sister companies. Particularly in the local market, personal guarantees are given for the liabilities of private companies by their directors who are usually also members (commercially speaking, the shareholders).

### Liens

Generally, a lien is a creditor's right to retain possession of his debtor's personal property (chattels) until the debtor pays his debt. It confers NO power of sale. Liens can arise from statute (Contract Law, Chapter 149 - **Cap 149**) or from a contract (including the articles of association of a company). A lien is founded on possession - that is to say, the creditor must obtain possession by lawful means, and not for a purpose inconsistent with a lien (such as to sell). Assets subject to a lien cannot be seized by third parties claiming against their owner, nor can the owner's successors in title obtain possession without paying the debt. The lien thus provides the debtor, and in the event of insolvency or bankruptcy, the debtor's receiver, liquidator or trustee in bankruptcy, with an incentive to pay the debt in full. This incentive is augmented where the property is worth significantly more than the debt in question.

The unpaid seller's lien arises under the Sale of Goods Law, Law 10(I)/1994 (**SGL**). Even if property (title/ownership) has passed to the buyer, and even if the seller is in possession as the buyer's agent, the seller may retain possession of goods until the seller is paid the price of the goods, provided that the seller has not sold on credit, or, if that is the case, either the period of credit granted has expired, or the buyer has become insolvent. The lien is of course lost if the seller chooses to waive it.

### Pledge

A pledge is a type of bailment. Personal property capable of being (actually or constructively) delivered is deposited by the debtor (usually a borrower or a guarantor), the so called pledgor, with the creditor (usually a lender), the so called pledgee and thus delivering possession of the property concerned to the pledgee. The property will be returned upon repayment of the debt (or the discharge of some other liability).

Unlike a lien, a pledge confers not only possession but also the right of sale, the so called power of sale, (and power to confer title/ownership on a purchaser) if repayment is not made and the property is not reclaimed within an agreed period of time. A lien is a personal right and it is not transferable. A pledge is assignable.

In practice today the pledge of shares is a very common form of security in commercial transactions or loans.

## (Traditional) mortgage

Under a traditional mortgage of immovable property or personal property, the debtor (usually a borrower or a guarantor) the so called mortgagor, remains in possession of the mortgaged property. A legal mortgage transfers title/ownership in the property to the creditor (usually a lender), the so called mortgagee, together with a combined power of foreclosure and sale upon a default in repayment. This power is vested by the instrument creating the mortgage. On redemption (ie repayment), title/ownership is vested back to the mortgagor.

An equitable mortgage may be created:

- By an express document agreeing, under certain circumstances (eg an event of default), to transfer the legal title/ownership in the property to the creditor (**Equitable Mortgage A**); or
- By way of deposit of the instruments/documents of title/ownership to the relevant property (such as a blank (but otherwise executed by the transferor) instrument of transfer of shares/debentures, or share/debenture certificates) with the creditor (**Equitable Mortgage B**)

On default, under either type of equitable mortgage, the lender has the right, in equity, to compel the debtor to convey to the creditor legal title/ownership in the property for the purposes of sale. Upon repayment the agreement is terminated (in the case of Equitable Mortgage A) or the instruments are returned as appropriate (in the case of Equitable Mortgage B). Equitable Mortgage A and Equitable Mortgage B are not mutually exclusive; they may coexist in relation to the same property in favour of the same mortgagee.

There is a notable distinction between:

- Documents/instruments deposited as security for the debt (or some other liability) which are certificates (ie evidence of title/ownership); and
- Documents deposited as security for the debt (or some other liability) which EITHER give the possessor the right to take immediate possession of the relevant property OR the deposit of such documents itself transfers title/ownership to a chose in action, such as bearer bonds or bearer shares, or other negotiable instruments payable or endorsed to bearer (eg promissory notes payable to bearer or endorsed to bearer under the Bill of Exchange Law, Cap 262)

A deposit of documents under (b) may be regarded NOT as an equitable mortgage but as a pledge of the relevant property (goods or chose in action). This distinction is important for it will determine the rights of the secured creditor (including the steps required to exercise disposing powers) but also the steps required to be taken to “perfect” the security (see section below on Registration).

A mortgage differs from a pledge. The mortgagee acquires general title/ownership in the mortgage property, subject to the mortgagor’s right to redeem. By a pledge the general title/ownership remains with the pledgor and the pledgee has no right of foreclosure but merely a right to sell. Ultimately the question whether the particular security is a mortgage or a pledge only, will be determined by reference to the intention of the parties and other surrounding circumstances. Nevertheless, there can be a pledge of personal property and also mortgage of personal property. There can be a valid mortgage of personal property, and when not accompanied by delivery of possession, is still operative as a security (mortgage only), save and except against a third party acting in good faith without notice.

An Equitable Mortgage B is still widely used. Such a mortgage coupled with a share pledge is particularly used in relation to shares. However, the traditional mortgage is nowadays becoming increasingly redundant as it is increasingly being replaced by the charge.

## Charge

A charge gives the right to the creditor to resort to identified property, immovable property or personal property, to satisfy the debt (or some other liability) if not paid/repaid (or satisfied/discharged). Neither possession nor (unlike a traditional mortgage) title/ownership, passes to the creditor. Instead the creditor may call for the assignment/transfer of the property to the creditor himself if the debt is not paid/repaid or satisfied/discharged when due. The most appropriate remedy is to appoint a receiver who takes control of the property for the purpose of selling it, satisfying the debt, and handing the balance, if any, over to the debtor. It is preferable to appoint such a receiver by the instrument/agreement creating the charge, or if not, a statutory receiver may be appointed (in the case of immovable property) under statute. Indeed a charge is very similar to a mortgage in that it gives all the rights of a mortgagee without the need of transferring possession or ownership.

Charges can arise either as a result of an agreement or by operation of law. In commercial circumstances, the charges arising by operation of law which are most commonly met with, are those imposed under the equitable doctrines and statutory (Cap 149) provisions relating to the tracing of property (and the proceeds thereof) which has been entrusted to a bailee or fiduciary and has been misapplied by him.

Express charges can be either fixed or floating. A fixed charge is created over particular assets (including deposits of cash held in a bank or by another person). In relation to immovable property, an express charge is still termed a

“mortgage”, but has nevertheless effectively substituted the use of the traditional mortgage.

Apart from immovable property and capital assets, fixed charges are not practical on assets such as merchandise (stock in trade) as these are constantly being replaced (turnover). In such a case, fixed charges would therefore need to be constantly created and released; this is impractical in the least. Instead, a “floating” charge should be created over all the assets of the business from time to time, or perhaps one class of assets, such as book debts or stock in trade. This floating charge ‘hovers’ over the changing/circulating assets in the course of trading and carrying on business, until a default occurs. The charge then ‘crystallises’ and attaches to all the assets (or the particular class of assets) held as at that time and a receiver is then appointed to take control of those assets.

## Registration

The problem with all forms of charges (fixed or floating or mortgages), whether they are security for commercial transactions or loans, is that the debtor remains in possession of the charged assets. Consequently, the debtor continues to present an appearance of wealth to other (unaware) persons dealing with the debtor. Accordingly, the debtor can “disappear” with the proceeds of the disposal of such assets, leaving the original creditor and the unaware purchaser with a dispute over the assets concerned. A desire to make such charges public in order to avoid fraud, deceit, trickery and similar activity has resulted in the application of the concept of registration.

There are three regimes governing registration of securities, which overlap to some extent. These are generally as follows:

- Registration in a statutory registry relating to the asset concerned. This depends on the type or nature of the asset. For example, in relation to security interests over immovable property situated in Cyprus, the relevant statutory registry is the Land Registry. A mortgage created over immovable property in Cyprus by any person (whether an individual or a corporation) is invalid unless it is registered at the Land Registry (s5 of the Immovable Property (Transfer and Mortgage) Law, 1965, Law 9(I)/1965 (L65)). Another example concerns the mortgaging of ships, which are similarly registrable at the Department of Ports of the Ministry of Communications and Works under the Merchant Shipping (Registration of Ships, Sales and Mortgages) Law, 1963, Law 45(I)/1963.
- Certain charges (the term includes mortgages) created by a company or created in any other way over its undertaking or over any of its property (immovable or otherwise) are void against the liquidator and any creditors unless registered with the Registrar of Companies – ss90–97 of the Companies Law, Chapter 113 of the statute laws of the Republic of Cyprus (**Cap 113**). This applies to companies incorporated or liable to be wound up under Cap 113.

- All charges (the term includes mortgages) created by a company over its assets must also be registered in the register of charges or mortgage book which are part of the company’s statutory books (ss98–100 Cap 113). This requirement is wider than that under ss90–97 Cap 113. However, the effect of not doing so does not invalidate the charge in any way, but renders the directors in default liable to a fine.

The overlap arises where the charge (the term includes a mortgage) in question should be registered:

- At the statutory registry (whether the property belongs to an individual or a corporation)
- At the Registrar of Companies
- In the company’s statutory books

Charges must always be registered in the company’s statutory books, and, depending upon their nature and the property concerned, may also require registration at the Registrar of Companies as well as at some other statutory registry (eg the Land Registry in the case of immovable property).

Although a legal mortgage/charge over immovable property can only be created by a written instrument, an equitable mortgage over immovable property can be created either by a written instrument or other express document, or by deposit of certificates of title/ownership (title deeds). It is noteworthy that under L65, a mortgage over immovable property must be registered at the Land Registry or else it will be invalid against all persons (including the mortgagor and mortgagee as well as the liquidator, trustee in bankruptcy, official receiver and any creditor or third party). By contrast, failure to register under Cap 113 will render the mortgage/charge void only against the liquidator and any creditors, but the guarantee or the liability upon which the security was created and the security interest per se (and thus the disposing powers under it), remain valid as between the mortgagor/chargor and the mortgagee/chargee.

In theory, any mortgage or charge of personal property can be created orally (and perhaps later evidenced in writing) and an equitable mortgage of personal property can also be created by depositing the relevant documents of title/ownership (see above “Equitable Mortgage B”). These security interests are caught by the statute as charges which require registration, for s90 Cap 113 makes reference to the creation of the charge not the manner in which it is created. However, although the term ‘charge’ is very wide, s90 Cap 113 is quite prescriptive as to the types of property over **which** charges must be registered. These are the following (s90(2) Cap 113):

- A charge for the purpose of securing any issue of debentures;
- A charge on uncalled share capital of the company;
- A charge on book debts of the company;

- A floating charge on the undertaking or property of the company;
- A charge on calls on shares made but not paid [in respect of partly paid shares];
- A charge on a ship or any share in a ship;
- A charge on goodwill, on a patent or a licence under a patent, on a trade mark or on a copyright or a licence under a copyright;
- A charge on any other movable property created or evidenced by an instrument where the company retains possession of such property;
- A charge on immovable property, wherever situate[d], or any interest therein.

In circumstances where the lender/chargee is not certain whether a particular security interest falls within the scope of the above prescribed charges, it is nevertheless advisable to procure, or insist on, the registration of the security interest if at all possible. This is of particular relevance to a security in the form of a pledge of shares. It is submitted that since possession of the pledged property is delivered to the pledgee, the pledgor does not retain possession of the pledged property and therefore the security of pledge falls outside the scope of s90(2)(h) and as such it is not a charge to which s90 applies or which otherwise requires registration.

Some practitioners interpret “possession” by reference to the ability of the pledgor to exercise some form of control over or in respect of the pledged shares (other than disposing powers), such as voting powers/rights derived from the shares per se (as class right) or the ownership of the shares. We do not share the same view. Nevertheless, such powers/rights of control can be restricted entirely in the contract of pledge thereby depriving the pledgor from these rights or powers and any kind of possession.

A recent amendment to s90 attempted to clarify that the security of share pledge does not require registration by expressly excluding the application of s90 to such pledge. However, this amendment led to further uncertainty causing many practitioners to continue advising in favour of the registration of share pledges.

In our view, the position would have been settled had the amendment instead focused on the meaning of possession. Nevertheless, the amendment is a statement of the existing legal position that a share pledge does not require registration.

## Retention of title clauses

The right of retaining the title/ownership in the goods sold arises under s19 of the SGL, pursuant to which the property (ie the title/ownership) in the goods passes to the buyer at such time as the parties intend for it to pass. Thus SGL, s19 permits the seller to delay the passing of title/ownership

pursuant to the contract, even after delivery has taken place, until a specific condition (in this case payment for the goods) has been fulfilled. Hence the existence of retention of title clauses in contracts for the sale of goods.

Retention of title clauses are useful in situations of insolvency. The seller can recover the goods as the goods belong to the seller and therefore the seller has priority in relation to those goods to other creditors of the buyer. A practical result of this is that the seller does not have to prove the debt owed to him in the insolvency proceedings together with other ordinary (non-secured) creditors.

Such clauses are most useful when dealing with easily identifiable goods. In such a case, simple clauses such as the following will suffice: “Property in the goods will remain with the seller and shall not pass until payment in full for the goods has been received by the seller”.

There are ancillary provisions which may supplement the retention of title clause. These include provisions to the effect that the risk passes to the buyer on delivery even though the property (title/ownership) itself does not; that the seller has the right to enter the buyer’s premises to repossess the goods; and that the buyer must insure the goods against loss or damage.

A significant problem presented by the use of retention of title clauses arises from the fact that under the SGL (s30), Cap 149 (see sections on Bailment (Part XII) and Agency (Part XIII)) and principles of estoppel, the buyer of goods – notwithstanding the existence of a retention of title clause – is still able to pass valid title to a third party who acts in good faith and without notice of the retention clause (or the retention itself). Problems will also arise where the buyer mixes or uses the goods in the normal course of business. In such a case the seller will want (and accordingly will need to provide for in the contract) rights to enable the seller to trace the proceeds of sale or the goods in their new form.

An effective retention of title clause should retain the entire property (title/ownership) in the goods; reserving/retaining merely a beneficial/equitable interest in the goods will create an equitable charge which must be registered against the buyer (if a company) under s90 Cap 113, or else it will be void against the liquidator or any creditor of the buyer.

An unpaid seller who has delivered goods under a retention of title clause cannot, under s56(1) SGL, sue for the price, since under s56(1) the seller can only sue for the price when title has passed to the buyer unless pursuant to s56(2) SGL, the price has to be paid on a ‘defined day’. This problem can therefore be avoided by expressly imposing an obligation on the buyer to pay the price on a specified date.

Creditors are afforded a multitude of options to protect their interests, particularly where the debtor concerned is a company and therefore has public registers available to be searched. Even in the case of individual debtors, with the exception of specific security-interests which must by virtue of a statute be registered to offer full security to the creditor (for example a mortgage on land), creditors are also afforded protection even in the case of a non-registrable charge of an asset (where there is no statutory registry

available) against a debtor who is an individual. Such a charge will nonetheless be recognised by the trustee in bankruptcy/official receiver, under the Bankruptcy Law Cap 5. The registration system in itself is a mechanism which provides business and the wider public with a venue to ascertain the encumbrances accompanying an asset. Ultimately, especially since businesses are mostly carried on by companies, creditors benefit from heightened protection to ensure they will be able to recover payment, in turn enabling business transactions to unfold with certainty and allowing transactions to be more streamlined.



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