Chapter 1

Introduction

Over many years, commentators have observed that the law governing credit security over personal property in common law jurisdictions (such as Australia, England, Malaysia and Singapore) is generally complex, cumbersome and inadequate, and have called for radical reform of the law.[1] The same is true of the Hong Kong Special Administrative Region

[1] For example, in Australia, the Australian Law Reform Commission Report No 64, Personal Property Securities (1993), para. 1.11, opined that there were serious inadequacies in the existing law governing secured lending over personal property, and recommended reform. Currently, the Australian Personal Property Security Law Reform Committee has produced a new bill based on a notice-filing system to replace the existing law. The English Law Commission Consultation Paper No 164, *Registration of Security Interest: Company Charges and Property Other than Land* (July 2002), as modified by the Consultation Paper No 176, Company Security Interests: A Consultative Report (August 2004), proposed radical reform of the present legal framework governing the creation and perfection of security of personal property of companies, and of corporate and non-corporate businesses. The English Law Commission Report No 296 (August 2005), based on the views elicited in response to Consultation Papers Nos 164 and 176, was limited only to reform of corporate security in a narrow sense and certain sales of receivables by companies; changes to this aspect of the law have been included in the Companies Act 2006. The original Law Commission paper recommended that a new notice-filing system along the lines of Article 9 of the Uniform Commercial Code (Revised) of the United States of America should be seriously considered for adoption in the UK. This conclusion followed a series of company law reviews carried out by the UK Department of Trade and Industry (DTI), notably Final Report, Modern Company Law for a Competitive Economy (URN 01/942, 26/7/2001) and the recent DTI consultation document, The Registration of Companies' Security Interests (Company Charges) – The Economic Impact of the Law Commissions' Proposals (July 2005). Earlier reports that criticised the existing legal framework and called for reform included the Crowther Report, Consumer Credit, Cmnd 4596; and A.L. Diamond, *A Review of Security Interests in Personal Property* (London: HMSO, 1989), particularly para. 17.17, p. 1. In New Zealand, the New Zealand Law Commission Report No. 8, A Personal Property Securities Act for New Zealand, Wellington Law Commission, April 1989, p. 1, commented that its legal framework was a 'quagmire' and badly in need of reform. The New Zealand Law Commission's earlier Preliminary Paper No. 6, Reform of Personal Property Security Law (1989) (J.H. Farrar and M.A. O'Regan), stated (p. 10), 'The law relating to security over personal chattels and intangibles in New Zealand is in a mess'. In 1999, New Zealand, in pursuance of the recommendations, enacted the Personal Property Securities Act 1999 (No. 126) ('PPSA').

('Hong Kong').[2] Being a former British colony, Hong Kong's legal system has a common origin with and exhibits similar features to these jurisdictions.[3] However, the Hong Kong Law Reform Commission has yet to turn its attention to this topic and call for a comprehensive review of the existing structure of credit security law affecting personal property.

China's legal system largely follows the continental civilian model and has not yet enacted a comprehensive civil code despite almost thirty years of transition from a classical socialist model to one that more closely resembles capitalism. Although the influence of common law systems has become more noticeable in Chinese law in recent years, the fundamental concepts and principles of Chinese civil law originate from the German paradigm.[4] Intensive legislative effort in the last twenty years has begun to create a unified and systematic legal framework. However, its credit security legal framework over personal property has been generally recognised as being both inadequate and ineffective.[5] Despite this state of

This basically adopted the notice-filing system, and it came into force on 1 May 2002 (Commencement Order 2002/60). In respect of Malaysia and Singapore, see D.E. Allan, M.E. Hiscock and D. Roebuck, *Credit and Security – The Legal Problems of Development Financing* (St Lucia: University of Queensland Press, 1974), pp. 31–40, where the authors commented that the credit security laws of these jurisdictions were generally cumbersome and inadequate.

[2] Hong Kong comprises the island of Hong Kong, the Kowloon Peninsula, the New Territories and a number of outlying islands (see Schedule 2 of the Interpretation and General Clauses Ordinance (Cap. 1)). All came under British rule at different times in the nineteenth century (see G.B. Endacott, *Government and People in Hong Kong 1841–1962 (A Constitutional History)* (Hong Kong: Oxford University Press, 1983), pp. 124–5). The British colonisation of Hong Kong officially began on 26 June 1843. The People's Republic of China resumed sovereignty over Hong Kong on 1 July 1997.

[3] By virtue of a series of colonial ordinances, namely Ordinance No 6 of 1845, §4, Ordinance No 2 of 1846, §3 (repealed), the Supreme Court Ordinance 1873 (repealed), and the Application of English Law Ordinance (Cap. 88) of 1966 (repealed) ('AELO'), English law comprising English legislation and common law and equity were, subject to limitations, applicable to the colony of Hong Kong. The limitations were: (a) where the English law was inapplicable to the circumstances of Hong Kong or its inhabitants: §3(1)(a) AELO; (b) where it was applicable but subject to such modifications as such circumstances may require: §3(1)(b) AELO; and (c) where its application was annulled by any order in Council, any English Act which applied to Hong Kong, or any Ordinance: §3(1)(c) AELO. The AELO was repealed by Annex 1, para. 2 of the Decision of the National People's Congress Standing Committee made on 23 February 1997. However, English common law and equity as a source of Hong Kong law was preserved by the Basic Law, Article 8.

[4] Bing Ling, 'Civil Law', in Chenguang Wang and Xianchu Zhang (eds.), *Introduction to Chinese Law* (Hong Kong: Sweet & Maxwell Asia, 1997).

[5] Chi Zhang, 'Some Thoughts on Security over Movables', *Law Science* 4 (2003), 64; Nengbi Yu and Xianglei Hou, 'Drawbacks and Perfection of Registration Rules of Security over Movables in China', *Law Science* 5 (2001), 33; Jinguang Xiong, 'Drawbacks and Perfection

affairs, no comprehensive review of the credit security legal framework has been undertaken in China. As part of the process of drafting a new comprehensive Civil Code, the method of improving the current credit security provisions has attracted the attention of many Chinese civil law scholars and caused a fierce debate amongst them.[6] The standalone provisions of the Security Law (1995) relating to this topic will be examined, as will the new provisions in the Property Law (2007) which form a major part of the legislation that will eventually be incorporated into the new Civil Code.[7]

1.1 Objective, hypothesis and significance

In view of the inaction noted in Hong Kong and the recent legislative activity in China, the objective of this book is to answer the following questions:

- Does the credit security legal framework governing security over personal property in Hong Kong and China function efficiently?
- Is there a need to reform the existing legal framework in Hong Kong and is the new Chinese law appropriate?
- What particular form and direction should the new legal framework take in Hong Kong and what revisions are needed to the Chinese system?

To help answer these questions and thus achieve this objective, the following hypothesis is postulated: the credit security legal frameworks governing security over personal property in domestic credit security arrangements in Hong Kong and China are not efficient if they fail to promote effectively the functions of (i) reducing the financial risk of the secured creditor, (ii) asset utilisation, (iii) fraud prevention and (iv) cost

of Chattel Mortgage Registering Institution in our Country', *Hebei Law Science* 22(5) (2004); Fumin Jiao, 'Legal Reflections on Perfection of Pledge Rules in China', *Law Science Magazine* 23(5) (2002), 36.

[6] Shengping Gao, *Studies on Chattel Mortgage* (Beijing: China Industry and Commerce Press, 2004); Benhan Chen, *A Comparative Study of Security Law* (Wuhan: Wuhan University Press, 2003).

[7] The official English translation of the Security Law (1995) can be found on the website of the National People's Congress, the People's Republic of China. See www.npc.gov.cn/zgrdw/english/news/newsDetail.jsp?id=2204&articleId=345071 (English). The Chinese version can be found at www.npc.gov.cn/zgrdw/common/zw.jsp?label=WXZLK&id=339451&pdmc=1502 (Chinese); another unofficial translation can be found at www.lawinfochina.com/law/display.asp?db=1&id=6642&keyword=propertylaw.

minimisation through four functional mechanisms, namely (a) creation, (b) perfection, (c) publicity and (d) enforcement of such security.

This book is thought to be the first detailed critical analysis of this subject as regards the law in Hong Kong and China.

The book will, we hope, provide new insights as to how these two substantially different legal systems function, both in theory and in practice, as regards the taking of security over personal assets. The book will also discuss issues concerning the relevance of law in relation to the contemporary commercial environment in Hong Kong and China. Finally, it will offer suggestions for reform of the credit security laws of other Asian jurisdictions to promote greater economic efficiency and legal certainty.

1.2 Methodology

In the social sciences, two types of research methodology can be discerned. The first is the 'verification-of-hypothesis method' or 'theory-methodological' approach (the 'verification approach').[8] The second is the grounded theory methodological approach ('grounded theory approach'), which was originally developed by the sociologists Glasser and Strauss.[9]

The verification approach involves two stages. The first is the construction of a hypothesis. The second is the testing of this hypothesis in a defined environment using a qualitative or quantitative method.[10] The qualitative method focuses on the collection and examination of data from personal observations, interviews, documents, journals, books and videotapes.[11] In contrast, the quantitative method focuses on the examination of statistical data collected, usually by means of empirical surveys.[12]

[8] See B.G. Glasser and A.L. Strauss, *The Discovery of Grounded Theory: Strategies for Qualitative Research* (New York: Aldine De Gruyter, 1967), pp. 10–15.

[9] Ibid.

[10] Whether one or the other should be used depends on the circumstances; see Glasser and Strauss, above, note 8, p. 17. See also M.B. Miles and A.M. Huberman, *Qualitative Data Analysis – A Sourcebook of New Methods*, 3rd printing (Beverley Hills, CA: Sage Publications Inc., 1985), p. 215; and K.M. Eisenhardt, 'Building Theories from Case Study Research', *Academy of Management Review* 14 (1989), 532 at p. 535.

[11] See Glasser and Strauss, above, note 8, p. 18. The other method is called the quantitative method. Here the findings of the research are arrived at by means of statistical procedure or other means of quantification: see A. Strauss and J. Corbin, *Basics of Qualitative Research* (London: Sage Publications Inc., 1990), p. 17.

[12] See Glasser and Strauss, above, note 8, p. 18.

Grounded theory, as defined by Glasser, is a general methodology of analysis linked with data collection that uses a systematically applied set of methods to generate an inductive theory about a substantive area.[13] The end result is the development of theories or hypotheses, without testing such theories or hypotheses. The testing or verification is left to others interested in these areas of research. This approach is particularly useful in areas in which there is an absence of theory or hypotheses.

The present book adopts the verification approach and the qualitative method of verifying hypotheses. This approach and method fit very well with the type of work undertaken here, because the existing credit security legal framework of Hong Kong is constant and well settled, and has a rich source of case law and statute with well-developed systems of law reporting. However, in China the system is, in many ways, much more rudimentary and lacks many of the attributes of a well-settled jurisprudence as might be found in established civilian jurisdictions such as Germany, Japan or France. Despite this problem, the ongoing process of creating a Civil Code, and the enactment of the Security Law and the Property Law, together with a significant Supreme Court Interpretation of the Security Law in 2000, does provide a sufficient basis for proper analysis. Further, the existing provisions in the Security Law have been well tested, and have been re-enacted in the new Property Law, thus providing some legislative stability in this area.

1.3 Key constructs of the hypothesis

The key constructs of the hypothesis are:

- the functions of financial risk reduction, asset utilisation, fraud prevention and cost minimisation in any security device;
- the creation, perfection, publicity and enforcement of such security devices; and
- the efficiency of such measures.

The functions of credit security, and the form of an efficient credit security legal framework to realise these functions, are matters of debate. Theories on the subject range from broad economic concepts, such as the promotion and development of a country's commerce and functioning

[13] B.G. Glasser, *Basics of Grounded Theory Analysis* (Mill Valley, CA: Sociology Press, 1992), p. 16.

financial markets,[14] leading to an expansion of a country's gross domestic product (GDP),[15] to narrow concepts, such as the reduction of the cost of borrowing,[16] the encouragement of creditors to lend to risky businesses (which they would otherwise refuse),[17] reduction of creditors' administrative costs in monitoring the loan, and the financial performance of the debtor.[18] Although it is generally recognised that the grant of security to creditors has a positive effect on economic activity, there are conflicting views as to the extent to which it does;[19] but it is not within the ambit of this book to verify which of these is correct. In addition, as Duggan has commented, it is not easy to determine precisely what constitutes an

[14] See F.S. Mishkin and S.G. Eakins, *Financial Markets and Institutions*, 2nd ed. (Reading, MA: Addison-Wesley, 1998), pp. 14–15; and R. Eyre, 'Collateral Security Damages', in 'Legal and Judicial Reform in Asia: Agenda for the New Millennium', Roundtable Meeting of Chief Justices and Ministers of Justice, Asian Development Bank (25 August 1997); available at www.adb.org/Documents/Conference/Seminar_Roundtable/round070.asp.

[15] See Eyre, above, note 14. The author noted that without such a legal framework no capital would be available and estimated that there would be a loss of between 5 and 10 per cent of GDP. A similar view was adopted by D. Fairgrieve, 'Reforming Secured Transaction Laws in Central and Eastern Europe', *EBLR* 9(7/8) (1998), 254.

[16] The argument is that the higher the risk, as in unsecured lending, the higher the interest; see S. Levmore, 'Monitor and Freeriders in Commercial and Corporate Setting', *Yale LJ* 92 (1982), 49–51.

[17] A. Schwartz, 'Security Interests and Bankruptcy Priorities: A Review of Current Theories', *JLS* 10 (1981), 1–37.

[18] See ibid., pp. 9–11; P. Jackson and A.T. Kronman, 'Secured Financing and Priorities among Creditors', *Yale LJ* 88 (1979), 1143 at p. 1147; R. Posner, *Economic Analysis of Law*, 3rd ed. (Boston: Little, Brown, 1986), p. 373: and see M. Gillooly (ed.), *Securities over Personalty* (Annandale, NSW: Federation Press, 1994), p. 241. They effectively suggested that 'the advantage of taking security is that it enables the creditor to focus its monitoring efforts more narrowly on a particular asset, whereas an unsecured creditor must monitor dealings in all the debtor's assets'. Note, however, that literature on the management of problem loans and loan losses by banks did not suggest that there was any difference in demands on managing secured loans and unsecured loans: see T.W. Koch, *Bank Management*, 3rd ed. (Fort Worth, TX: Dryden Press, 1995), Chapter 23, pp. 733–61.

[19] For example, the theory that an efficient credit security legal framework promotes the development of a country's commerce and a fully functioning market economy (see Mishkin and Eakins, above, note 14; and Eyre, above, note 14) is doubted by the views of Allan, Hiscock and Roebuck, above, note 1, pp. 3–4. See also J.J. Norton and M. Andenas (eds.), *Emerging Financial Markets and Secured Transactions* (London: Kluwer Law International, 1998) for discussion of the criticisms of the theories, in particular Chapter 3, H.W. Fleisig, 'Economic Functions of Security in a Market', pp. 21–25; also R.J. Mann, 'Explaining the Pattern of Credit', *Harv LR* 10 (1996–7) 625 at p. 633, where the author states, 'no single factor can capture the multiple and interrelated considerations that motivate borrowers and lenders as they structure their various transactions'.

efficient credit security framework and what direction law reform should take from an economic perspective.[20]

This book therefore emphasises the functions of a credit security legal framework from the perspective of creditors, debtors and third parties who might deal with the debtor in respect of the same secured asset as a subsequent purchaser or creditor.[21] This approach is adopted because these players are participants in real businesses with direct economic interests in the security arrangement.[22] They are not abstract economic actors. Their perceptions of what might be the appropriate function of a credit security legal framework are real and substantial.

What are their perceptions? The most serious concern of the creditor is the risk of being unable to recover the amount due if the debtor becomes insolvent,[23] because after the debtor's property has been distributed amongst secured creditors and preferential creditors, nothing may be left for unsecured creditors.[24]

Thus, from the point of view of the creditor, security reduces the creditor's financial risk associated with advances[25] by allowing the creditor to

[20] A.J. Duggan, 'Personal Property Security Interests and Third Party Disputes: Economic Considerations in Reforming the Law', Chapter 9 of Gillooly, *Securities over Personalty*, above, note 18.

[21] According to the Asian Development Bank (*Law and Policy Reform at the Asian Development Bank* (2000 ed.), vol. 2, para. 11, p. 3), the persons who might be interested in a secured transaction comprise a broad spectrum of persons, including the producers and suppliers of goods and services; the consumers; and the banks, savers and other financial intermediaries. This concept is too broad to provide a working definition for the present book. This book adopts the position that the creditor, debtor and third party are interested parties, as presented by J.L. Simpson and J.H.M. Rover, 'An Introduction to the European Bank's Model Law on Secured Transactions', in J.J. Norton and M. Andenas (eds.), *Emerging Financial Markets and the Role of International Financial Organizations* (London: Kluwer Law International, 1996), Chapter 10, p. 169. The authors opined that these three persons have direct legitimate interest in a credit security legal framework that fairly balances their competing interests.

[22] See Mann, above, note 19, pp. 630–1, 682, where the author postulates that abstract theory, however elegant, is not useful in studying the costs and benefits of secured and unsecured transactions, unless the analysis is focused on the actual decision makers.

[23] See Norton and Andenas, above, note 19, in particular Chapter 7, J.L. Simpson and J.H.M. Rover, 'General Principles of a Modern Secured Transactions Law', at pp. 144–6. See also Eyre, above, note 14, para. 11.

[24] See *Borden (UK) Ltd v Scottish Timber Products Ltd and Another* [1979] 3 All ER 961, 971, *per* Templeman LJ. See also *Law and Policy Reform at the Asian Development Bank*, above, note 21, para. 9, p. 3, where it was stated, 'Without a security interest, a creditor only has a general claim against a debtor's property.'

[25] See Eyre, above, note 14, section II: 'Taking security reduces risk and the cost of lending and contributes to sound banking practices.' See also the Australian Law Reform Commission Report No 64, above, note 1, para. 1.9, where it states, 'Securities … reduce

have priority recourse to the secured property.[26] In this regard the function of a credit security legal framework is that it must promote the creation of effective security that is capable of reducing the creditor's financial risk.[27]

For a commercial debtor,[28] the smooth functioning of its business depends on being able to pursue its operations without restriction and, subject to the security interests of the creditor, being allowed to use the secured asset productively in the ordinary course of business.[29] As Gough has observed, one of the expectations of a borrower is to 'avoid the need for detailed and intrusive supervision and control of its business operations, whether by a bank or any other credit supplier'.[30] Simpson and Rover have made a similar observation.[31] They postulated that, without this freedom, financing would often be useless to the debtor because the debtor's business and trade would be seriously impeded.[32] Thus, from the perspective of a debtor, the function of a credit security legal framework is to promote the debtor's utilisation of the secured asset in the widest possible range of situations.[33]

A third party who wishes to deal with the debtor in respect of the same secured assets as a potential subsequent creditor is concerned with two factors – (i) the status of the debtor's assets offered as security;[34] and (ii) the creditworthiness of the debtor.[35]

In the absence of an independent and reliable mechanism that allows the third party easy access to the required information, the third party

the risk that the money advanced will not be repaid by enabling the creditor to have recourse to the property secured'; and Simpson and Rover, above, note 21, p. 144.

[26] See the Australian Law Reform Commission Report No 64, above, note 1, para. 1.9; Mann, above, note 19, p. 639; and C.C. Wappett and D.E. Allan, *Securities over Personal Property* (Sydney: Butterworths, 1999), p. 4.

[27] See Simpson and Rover, above, note 23.

[28] The book is not concerned with consumer debtors.

[29] See R.W. Turner, *The Equity of Redemption*, reprint (Holmes Beach, FL: W.M.W. Gaunt & Sons Inc., 1986) pp. ix and 1; and see also R.L. Jordan and W.D. Warren, *Commercial Law*, 4th ed. (New York: Westbury, 1928), p. 13, where the authors expressed the view that the major disadvantage of the pledge was that it paralysed the debtor's business operation.

[30] W.J. Gough, *Company Charges*, 2nd ed. (London: Butterworths, 1996), p. 441.

[31] Simpson and Rover, above, note 23, p. 153, and also *idem*, above, note 21, at p. 169, where the authors say, 'the lender must obtain real benefit from holding security but not at the expense of depriving the borrower of the use of the assets given as security of the flexibility needed to operate an efficient business'.

[32] Simpson and Rover, above, note 23. [33] Ibid.

[34] This was one factor identified in the Australian Law Reform Commission Report No 64, above, note 1, para. 2.17.

[35] As postulated in Diamond, above, note 1, para. 11.1.5.

must rely on the goodwill and honesty of the debtor. However, in many cases, this is worthless. Furthermore, the absence of such a mechanism might subject the third party to the risk of loss of priority.[36] Thus, unsurprisingly, commentators on this issue have recommended that an efficient credit security legal framework must have an accurate and cost-effective publicity system.[37] Therefore, from the perspective of a third party, a credit security legal framework must contain an effective mechanism that protects the third party against the fraud of the debtor.

The creditor, debtor and third party are also concerned with the costs of creation, perfection, publicity and enforcement of security. As these costs are ultimately borne by the debtor,[38] high costs in any of these aspects mean that only large borrowers (who can bear such expense) can obtain credit.[39] This is not in the best economic interests of society as a whole or of the interested parties. Thus, to ensure that secured transactions are economically practical, the legal framework has to minimise the cost of creation, perfection, publicity and enforcement.[40]

A good credit security legal framework must therefore ensure that:

- the financial risk of the secured creditor is reduced in the event of default by the debtor ('reduction of risk' function);
- the debtor, as far as practicable, is able to continue to utilise the secured assets in the ordinary course of business ('asset utilisation' function);
- a third party is effectively protected against the fraud of the debtor in relation to the secured asset ('fraud prevention' function); and

[36] See *Law and Policy Reform at the Asian Development Bank*, above, note 21, at para. 267, p. 69.

[37] For example, the English Law Commission Report No 296, above, note 1; and the Australian Law Commission Report No 64, above, note 1, both advocated that the existing registration system be replaced with a notice-filing system. See also note 21 above, *Law and Policy Reform at the Asian Development Bank*, Part VII, 'Problems in Publicizing Security Interests', and Part VIII, 'Problems in Enforcing Security Interests'. See also Article 33 of the European Model Law on Secured Transactions at www.ebrd.com/sectrans/modelllaw5.htm, which sets out a purportedly efficient registration and information system.

[38] Fairgrieve, above, note 15, at p. 256. See also Gough, above, note 30, at p. 441, for a similar view on cost.

[39] See *Law and Policy Reform at the Asian Development Bank*, above, note 21, at para. 101, p. 19, and para. 10, p. xiv, where it was observed that if the process of creating secured transactions is expensive, only the largest borrowers can bear the cost. Further, in the event that the cost is borne by the creditor, the creditor will inevitably seek to recover the cost from the debtor: see Fairgrieve, above, note 15; and Gough, above, note 30.

[40] See Simpson and Rover, above, note 21, at pp. 145, 148.

- the costs of credit security arrangements are minimised ('costs minimisation' function).

This book contends that these functions are practical, substantive and conceptually sound. Accordingly, they form the central constructs of the hypothesis.

However, these functions are, in themselves, insufficient to provide clear direction on a number of critical issues – in particular, the formulation of the criteria to test the hypothesis, and the collection and analysis of data to substantiate the criteria. Two further steps are therefore necessary: (i) the identification and incorporation in the hypothesis of the essential functional mechanisms of creation, perfection, publicity and enforcement, and (ii) the identification and incorporation in the hypothesis of a mechanism that can confirm whether the legal framework has fully achieved its functions and has thus met the benchmark of efficiency.

1.3.1 Creation, perfection, publicity and enforcement of security

Four basic functional mechanisms can be identified in the security laws of Hong Kong and China, although they are not explicitly mentioned. However, Article 9 of the American Uniform Commercial Code describes three of the four mechanisms as being creation, perfection and enforcement.[41] Article 9 treats the fourth mechanism, publicity, as an aspect of perfection; however, for the purposes of this book, it is treated separately. Enforcement arises when the debtor defaults in the repayment of the credit. Each of mechanisms is linked to the objectives of the creditor, debtor and third party as discussed above. Indeed, the English Law Commission, in its Consultation Paper No 164 (2002), commented that these processes are inherent in the English credit security law, although they have not been explicitly stated as such.[42] The Consultation Paper No 176 (2004), on the other hand, has provided general explanations of the terms of attachment and perfection. Attachment is described as the point at which the secured party acquires a proprietary right in the collateral, and is a necessary step for perfection to occur. Perfection applies when a security interest has attached and it means completing the steps to secure,

[41] The first is called the 'attachment stage' (Article 9, §§201–10), the second 'perfection' (Article 9, §§308–16, sub-part 2, revised) and the third 'enforcement' (Article 9, §§601–24, Part 6, Revised).

[42] English Law Commission Consultation Paper No 164, above, note 1, para. 2.5.