RECENT DEVELOPMENTS

Predatory Commercial Loans — A Borrower's Dream or Nightmare?

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"*The rich rules over the poor, and the borrower becomes the lender's slave*." — Proverbs 22:7

In conventional financing, the traditional focus has been to protect the lender against borrower default risk. However, this article will examine how borrowers sometimes fall victims to predatory lenders. The article will seek to highlight some features to help identify predatory loans, and explain how these features could cause problems for borrowers. It will conclude with some lessons for borrowers to avoid these pitfalls.[1]

1. INTRODUCTION

The global COVID-19 pandemic has persisted since the first reported case in late 2019, with the threat of new variants increasing uncertainty about how quickly the pandemic could be overcome. The prolonged pandemic has brought about widespread economic disruption, with the International Monetary Fund predicting a gradually slowing global economic growth for 2022 and 2023.[2] Although COVID-19 infections in Asia have declined steadily,[3] the economic carnage still remains to fully play out.[4] The global economic situation is further exacerbated by the Russia-Ukraine military conflict that started on 24 February 2022,[5] and a looming global food shortage crisis.[6]

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[1] The views expressed in this article are personal, and do not necessarily reflect the views of the organisations that the authors are associated with. The law is stated as of 1 May 2022.

[2] See International Monetary Fund, "World Economic Outlook Update January 2022" (2022), online: *International Monetary Fund* <https://www.imf.org/en/Publications/WEO/Issues/2022/01/25/world-economic-outlook-update-january-2022>.

[3] Laura Spinney, "The 'zero-Covid' approach got bad press, but it worked — and it could work again" (28 March 2022), online: *The Guardian* <https://www.theguardian.com/commentisfree/2022/mar/28/no-covid-approach-bad-press-but-worked>.

[4] See Asian Development Outlook (ADO), "2021 Supplement: Recovery Continues" (2021), online: *Asian Development Outlook* <https://www.adb.org/sites/default/files/publication/755501/ado-supplement-december-2021.pdf>.

Against this background, many corporations and business owners in Asia are hit by cash straps due to business and industry disruptions. Many are struggling to raise new financing or to re-finance their existing debts. This has created a fertile ground for predatory lenders who would try to take advantage of desperate borrowers in the commercial lending context.

This article will highlight some features of predatory commercial loans, and explain how predatory lenders use these features to their advantage. It will conclude with some lessons for borrowers to avoid pitfalls and protect themselves.

The discussion in this article will focus on predatory commercial lending practices in Hong Kong, and will also discuss some UK and US reported cases, which serve to illustrate valuable lessons for borrowers.[7]

2. FEATURES OF PREDATORY COMMERCIAL LOANS

Predatory lending is not a new phenomenon in the financing market.[8] Such practices are often employed in the subprime mortgage market, where conventional banks are unwilling to extend financing to the would-be borrowers due to their questionable credit quality, track record and/or value of the collateral proffered.[9] These loans are characterized by excessively high interest rates or high fees, abusive or unnecessary provisions that do not benefit the borrowers, large repayment penalties, and underwriting that ignores the borrowers' repayment ability.[10]

Traditional literature had largely left predatory practices in the commercial lending context unexplored. As opposed to a consumer retail context, the borrowers in commercial lending are often thought of as being more experienced

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5 Tom Fairless, "Global Economy Braces for Impact of Russia's War on Ukraine" (7 March 2022), online: *The Wall Street Journal* < https://www.wsj.com/articles/global-economy-braces-for-impact-of-russias-war-on-ukraine-11646684060 > .

6 The Economic Times, "Ukraine invasion: Biden warns of significant food shortage risk following sanctions on Russia", 25 March 2022, online: < https://economictimes.indiatimes.com/news/international/us/ukraine-invasion-biden-warns-of-significant-food-shortage-risk-following-sanctions-on-russia/articleshow/90447961.cms?from = mdr > .

7 Financing arrangements in the Asia Pacific region (excluding Japan) are mostly entered into in Australia, PRC, Hong Kong, India, Singapore and Indonesia (see *Debtwire: 2021 Asia Pacific (ex Japan) Loans League Table Report*). Due to limited space, this article focuses on financings concluded in Hong Kong.

8 See < https://www.justice.gov/usao-edpa/divisions/civil-division/predatory-lending > .

9 See for example, James H. Carr & Lopa Kolluri, Fannie Mae Foundation, "Predatory Lending: An Overview" (2001), online: *Penn State University* < https://citeseerx.ist.psu.edu/viewdoc/download?doi = 10.1.1.729.5701&rep = rep1&type = pdf > .

10 See online: < https://www.investopedia.com/terms/p/predatory_lending.asp#:~:text = -Predatory%20lending%20is%20any%20lending,loans%20they%20can%27t%20afford > .

and business astute, financially literate and with a track record of financial history.[11]

However, predatory practices in the commercial lending context do exist. Predatory commercial loans may, for example, be designed with the objective of obtaining control or ownership of the borrower's collateral assets at a heavy discount. Identifying such predatory loans is difficult, since a loan provision considered predatory in one case may not be considered so in the case of another borrower. Nonetheless, predatory commercial lending practices usually have the following common characteristics: (a) the lenders target borrowers holding valuable collateral; (b) unreasonable loan terms; and (c) various obstacles to create challenges for the borrower to redeem its collateral. We will examine these in turn.

(a) Valuable collateral

Taking collateral from the borrower to secure performance is a common feature of conventional bank loans.[12]

From lenders' perspective, real property (including land leases, residential and commercial property) remains one of the most popular collateral. Traditionally, a borrower with valuable real property (especially in Hong Kong) will not have difficulty securing decent financing from a bank.[13] However, since 2012,[14] some borrowers in Hong Kong have been pushed to predatory lenders because Hong Kong banks are restricted by certain loan-to-value ratio (LTV) caps of as low as 30%. In August 2020, this LTV cap was relaxed slightly for non-residential properties,[15] but this may not be enough to create a lifeline for many commercial borrowers suffering from the ongoing economic crisis.

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[11] See for example, Comptroller of the Currency Administrator of National Banks, *Commercial Loans — Comptroller's Handbook* (1998), online: *Office of the Comptroller of the Currency*: < https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/files/commercial-loans/index-commercial-loans.html > . In Hong Kong, the Money Lenders Ordinance (Cap. 163) is also designed to protect consumer borrowers rather than commercial borrowers.

[12] See Charles Kerrigan, ed., *Practical Lending and Security Precedents* (London, UK: Sweet & Maxwell, 2019) at A-001-A-018 [Kerrigan].

[13] See Hong Kong Monetary Authority, "Half-Yearly Monetary and Financial Stability Report" (September 2019), online (pdf): *Hong Kong Monetary Authority* < https://www.hkma.gov.hk/media/eng/publication-and-research/quarterly-bulletin/qb201909/E_Half-yearly_201909.pdf > . In Hong Kong, banks' direct exposure to the property market (through loans secured by real property) in the second quarter of 2019 was nearly 30%, showing the relative ease of securing financing from a bank through real property as collateral.

[14] Hong Kong Monetary Authority, Prudential Measures for Property Mortgage Loans (September 2012), online (pdf): < https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2012/20120914e1.pdf > .

[15] Hong Kong Monetary Authority, Prudential Measures for Property Mortgage Loans (August 2020), online (pdf): < https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200819e1.pdf > .

Another popular collateral for conventional loans is publicly listed negotiable securities (such as shares, bonds, warrants and other derivative instruments).[16] However, listed securities with low trading volumes and low liquidity in the public markets may not be readily accepted by major banks as collateral.[17]

(b) Unreasonable loan terms

Predatory commercial loans usually feature one or more of the following characteristics:

(i) Low net loan proceeds

The lenders appear to give generous loans, but in effect, try to limit the net amount of the loan proceeds that a borrower will receive in various ways.

Lenders may insist that the funds are advanced to the borrower in tranches, whereas the borrower is required to transfer all its collateral assets to the lender immediately at the outset of the transaction.

Lenders may charge substantial upfront fees. Borrowers who are unable to secure financing through conventional sources usually have no choice but to accept such fees.

Lenders may try to push the borrower to accept a lower loan-to-value (LTV) loan. In other words, the face value of the loan is significantly less than the market value of the loan collateral. Commercial borrowers with poorer credit may be pressured to accept such conditions.

(ii) Non-recourse loan gimmick

A non-recourse loan is a loan where the lender waives its right to pursue the borrower for any shortfall in the difference between the proceeds from the sale of collateral, and the amounts owed by the borrower. In general, non-recourse provisions in loan agreements are legally enforceable.[18] This effectively means

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[16] See for example, Hong Kong Monetary Authority, "Supervisory Manual CR-G-7 — General Principles of Credit Risk Management" (2001), online (pdf): *Hong Kong Monetary Authority* <https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/supervisory-policy-manual/CR-G-7.pdf>.

[17] See Hong Kong Monetary Authority, "Research Memorandum 07/2018 Understanding Household Indebtedness in Hong Kong" (September 2018), online (pdf): *Hong Kong Monetary Authority* <https://www.hkma.gov.hk/media/eng/publication-and-research/research/research-memorandums/2018/RM07-2018.pdf>. As of late 2018, the maximum LTV ratios applied by most banks in Hong Kong for Hang Seng Index constituent stocks can be up to 60%, while those for other equity stocks are set at less than 40%. For investment-grade bonds, the maximum LTV ratios are around 70% to 80%, while that for non-investment grade bonds are less than 50%.

[18] See *Levett and Others v. Barclays Bank Plc.*, [1995] 1 W.L.R. 1260, where it was stated that if there is an exclusive method of repayment agreed between the lender and the borrower, the English courts will give full effect to the parties' agreement. See also Hugh Beale, ed., *Chitty on Contracts,* vol. 1, 33rd ed. (London, UK: Sweet & Maxwell, 2018) at 39-263.

that the lender may only look to the collateral for repayment in the event of a default, and the borrower is protected from personal liability.

It is worth noting that non-recourse obligations do serve genuine functions in financings. For example, it is commonly employed in securitization and structured financing transactions, especially to give independent directors comfort that they have no personal liability.[19] It is also used in trade finance and factoring arrangements, where sellers transfer assets to buyers on a non-recourse basis (under which buyers will only be able to rely on the underlying assets for cashflow payments), to give additional support for "true sale" analysis.[20] Under such scenarios, non-recourse obligations provide utility through risk allocation, allowing the contracting parties to effectively determine who shall bear the credit risks involved in a transaction based on factors including their relative bargaining powers and commercial considerations.

On its face, a non-recourse loan would benefit the borrower — it eliminates the borrower's personal liability and limits downside risk for the borrower if there is a loan default.[21] However, this is misleading. Predatory lenders are not concerned about recourse against the borrower, as they are focused on the collateral asset. There has been much scholarship focused on the risks and vices of non-recourse loans to the lender.[22] Without personal liability, borrowers may also act less prudently.[23]

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[19] See Marcus Sidki, "Securitization with Implicit Recourse: Some Thoughts on the Economic Rationale" (2014) 19:4 J. Structured Fin. 4 35. In a typical asset-backed securitization transaction, the underlying assets under the ownership of the originator are transferred to a special purpose vehicle by way of legal assignment. The securitization investors, therefore, have no right of recourse against the originator in terms of gaining access to assets not sold under the securitization transaction.

[20] The factors for true sale under English law established in *Inglefield Ltd., Re*, [1933] Ch. 1 (C.A.) (which is applied in most other common law jurisdictions like Hong Kong and Singapore) favour a non-recourse sale arrangement. For a further discussion on true sale under English law, see Kingsley Ong et al., "Repos & securities lending: the accounting arbitrage and their role in the global financial crisis" (2011) C.M.L.J. 92 at 95. However, it is worth noting that the absence of non-recourse is not necessarily fatal to a true sale analysis (see *Hallmark Cards Inc. v. Yun Choy Ltd.*, [2012] 1 H.K.L.R.D. 396).

[21] See for example *Hadrian S.Ä.r.l. v. Samuel Andrew Aitken and Others*, [2012] C.S.O.H. 84, [2012] 5 W.L.U.K. 583, where non-recourse language in a loan facility constructed to limit the creditor's claims to assets "expressed to be secured by any of the financing documents", obstructed the creditor from reaching into certain funds of the borrower syndicate which were paid for purposes of re-negotiation of the terms of the same loan facility.

[22] See Ron Harris and Asher Meir, "Non-recourse mortgages — A fresh start," (2013) 21 Am. Bankr. Inst. L. Rev. 119; Kaushik Basu, "Non-recourse mortgages and credit market breakdowns: a framework for policy analysis" (2011) 4:1 Macroeconomics & Fin. Emerging Market Economies 1; Andrey Pavlov & Susan Wachter, "Robbing the Bank: Non-recourse Lending and Asset Prices," 28:2-3 J. Real Est. Fin. & Economics 147; Solomon Dov & Odelia Minnes, "Non-recourse, no down payment and the mortgage meltdown: Lessons from undercapitalization" (2011) 16:3 Fordham J. Corp.

Non-recourse allows lenders to bargain for more favourable loan terms, in return for taking on seemingly higher risk and credit exposure on the borrower. These terms may include allowing the lenders to hypothecate, on-lend and further encumber the collateral assets to third parties.[24]

(iii) Type of security

Another feature of predatory loans is the lender typically prefers to avoid any public registrations or public disclosure requirements concerning the security taken over the borrower's assets. The absence of public registrations makes it easier for lenders to dispose of the collateral assets because prospective buyers will not have notice of the borrower's interest in the collateral assets.

Security over negotiable securities (including listed securities) is usually created by way of charge or mortgage, which are non-possessory in nature. During the term of the loan, so long as the borrower is not in default, the borrower continues to enjoy possession of the secured asset and receive the benefit of the asset. For example, in a charge over shares, the borrower typically continues to be recorded as the legal owner of the shares and enjoys dividends from the shares, but the borrower will usually be expected to (among other things) deliver a blank and undated signed stock transfer form so that the lender can easily enforce the share charge in the event of a borrower default.[25] Under Hong Kong law,[26] any charge or mortgage within the definition of "specified charge" under s. 334 of the Hong Kong Companies Ordinance (Cap. 622),[27] which is granted by Hong Kong companies or non-Hong Kong companies that are registered in Hong Kong, must generally be registered at the Hong Kong Companies Registry within one month of its creation.[28]

Instead of mortgage or charge, predatory lenders prefer the use of "pledge" to take security. The key differences of a pledge (as opposed to a charge or mortgage) include:

(a) A pledge is a possessory security. In other words, the lender must have possession or control of the collateral for the pledge to be effective.[29]

& Fin. Law 529 [Dov & Minnes]; Gregory M. Stein, "The Scope of the Borrower's Liability in a Nonrecourse Real Estate Loan" (1998) 55:4 Wash. & Lee L. Rev. 1207 [Stein].

[23] See Dov & Minnes, *supra* note 22; Stein, *supra* note 22.

[24] See the cases of *Quaestus Capital Pte Ltd. v. Everton Associates Ltd.* & *Binchuang Resources Co. Ltd. v. Lockwood Group Ltd.*, referred to in the "Recent Case Studies" section below.

[25] See Kerrigan, *supra* note 12 at D323, D326.

[26] Similar mandatory security registration requirements apply under English law and Singapore law. However, certain other jurisdictions like Cayman and BVI do not impose mandatory security registration requirement.

[27] A mortgage usually refers to a transfer of title over collateral assets by way of security; whereas a charge usually refers to a security without any transfer of title.

[28] Hong Kong Companies Ordinance (Cap 622), s. 335 and s. 336.

(b) A pledge usually does not need to be registered at public registers because a pledge is a security that is not within the definition of "specified charge" under s. 334 of the Hong Kong Companies Ordinance (Cap. 622).

Where lenders hold (or will end up holding) 5% or more of a Hong Kong listed company by way of security or otherwise, the lenders are required to file disclosure of interests to the Securities and Futures Commission.[30] This requirement applies whether or not the lender is resident in Hong Kong. Failure to make a disclosure when required is a criminal offence, with a maximum penalty of HK$100,000 fine and two years' imprisonment.[31] Predatory lenders (which are typically incorporated overseas) usually ignore their disclosure of interest obligations and choose not to file any disclosure of interest forms. They may also encourage borrowers to avoid their disclosure of interest obligations as well.

(iv) Weakened redemption rights

The borrower's right to redeem its collateral assets upon repaying its debts is commonly known as the "equity of redemption". Protection of this right is trite law, and the courts have traditionally ensured that any impediments or "clogs" on the equity of redemption are struck down.[32]

Predatory loans usually contain some or all the below features to weaken or completely extinguish the borrower's ability to redeem its collateral assets:

(a) Predatory loan contracts may provide for an outright transfer of the title over the collateral assets, with the lender only having the obligation to return "equivalent assets."[33] Such provisions have been upheld as legally enforceable.[34]

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[29] Traditionally, pledges were taken over negotiable securities in documentary form, such as bearer bonds, debentures, and negotiable certificates of deposit. However, in modern times, most securities are now dematerialized and held and traded on exchanges, and indirectly held through intermediaries in a pooled securities account. See: Louise Gullifer, ed., *Goode and Gullifer on Legal Problems of Credit and Security*, 6th ed. (London, UK: Sweet & Maxewll, 2017) at para. 6-07.

[30] As required under Part XV of the Securities and Futures Ordinance (Cap. 571). See online: <https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/outline-of-part-xv-of-the-securities-and-futures-ordinance-cap571-disclosure-of-interests/outlineofpartxvofthesecuritiesandfuturesordinancecap571disclosureofinterests.pdf>.

[31] Sections 328 & 351, Securities and Futures Ordinance (Cap 571).

[32] See: *Vernon v. Bethell*, (1762), 28 E.R. 838 (Eng. Ch. Div.), *Knightsbridge Estates Trust Ltd. v. Byrne*, [1940] A.C. 613, [1940] 2 All E.R. 401 (U.K. H.L.).

[33] This feature is commonly used in securities lending and repo contracts. Eg. Global Master Repurchase Agreement (GMRA) and Global Master Securities Lending Agreement (GMSLA) contracts. For avoidance of doubt, repo instruments are used for various short term secured lending, hedging, short selling, etc and are not considered predatory loans. However, predatory loans do make use of repo legal technology.

(b) The collateral assets may be commingled with the lender's own assets without segregation. The borrower risks losing its proprietary interest in the collateral assets once the collateral assets can no longer be readily identifiable.[35] This means the borrower may only have an unsecured claim against the lender for the return of the collateral assets (instead of a trust claim over the assets),[36] and the borrower will take full credit risk on the lender for the return of the collateral assets.

(c) Borrowers are usually restricted from early prepayment of the loan.

(d) Borrower are usually prohibited from demanding the return of some of their collateral assets while any portion of the loan remains outstanding.

(e) Lender usually has full power to dispose of, sell, transfer and rehypothecate the collateral without consent of the borrower. The agreement may, for example, state that the lender "has all rights associated with the collateral, including to sell, dispose of, short, lend, hypothecate and any rights offerings, options, warrants, distribution rights associated with the collateral." The lender's only obligation is to return equivalent cash or securities upon the borrower's repayment of the loan.

(v) Illegal or off-market clauses

Some clauses in predatory commercial loan agreements may appear relatively standard and boilerplate, but on closer examination, do not make commercial sense and may even be illegal.

One example of such a provision is an attempt to disapply the Money Lenders Ordinance (Cap 163 of the Laws of Hong Kong) (MLO). In Hong Kong, money lending is a regulated activity. Except for limited exceptions, no person can conduct the business of lending money[37] in Hong Kong without a

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[34] Such provision appears to be recognised and enforceable. See *Beconwood Securities Pty Ltd. v. ANZ Banking Group*, [2008] F.C.A. 594.

[35] If there is only commingling with the assets of other creditors of the lender (but not with the lender's own assets), the borrower's proprietary interest over the assets may still be preserved. For example, in the Singapore High Court case of *Pars Ram Brothers (Pte) Ltd (in Creditors' Voluntary Liquidation) v. Australian & New Zealand Banking Group & Others*, [2017] SGHC 38, the court held that despite the commingling of goods that are subject to several security interest, the secured parties retained a security interest in the commingled goods divided rateably in proportion to the value of their respective contributions.

[36] See Lynton Tucker, Nicholas Le Poidevin, & James Brightwell, *Lewin on Trusts,* 19th ed. (London, UK: Sweet & Maxwell, 2017), at 41-109 to 41-142. Trust assets may become untraceable as a result of commingling. The equitable interest of the beneficiary may be defeated by transfer to a bona fide purchaser for value of the legal estate without notice of the trust. Under both situations, the borrower may lose his trust rights to the collateral.

money lender licence issued by the Registrar of Money Lenders.[38] This licence is renewable annually.[39] The Police Commissioner is responsible for regulating and enforcing the MLO.[40]

The MLO contains certain provisions to protect borrowers against illegal money lenders. For example, an illegal money lender is not entitled to enforce the loan agreement or any security taken in respect of the loan.[41] Furthermore, the MLO imposes numerous restrictions on the substantive terms of a loan. Under MLO section 24, it is illegal for any lender (even those lenders with a money lender licence) to charge interest at a rate that exceeds 60% per annum. Any attempt to charge interest at a rate that exceeds 48% per annum is also deemed to be extortionate under MLO section 25(3).[42] Breach of these provisions will generally render the loan agreement unenforceable.[43]

The MLO has a built-in anti-avoidance provision. MLO section 1(2) restricts the ability of the parties to contract out of or contract to avoid the application of MLO. Although there is some doubt as to whether a loan agreement that has no Hong Kong nexus and is not governed by Hong Kong law will be subject to the MLO,[44] learned commentators currently take the view that even when a loan agreement does not appear to have nexus to Hong Kong, as long as Hong Kong law is chosen to govern provisions of the loan agreement, the MLO should apply.[45]

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[37] See MLO s. 2(1). The business of money lending is broadly defined as that of making loans, or advertising, announcing or holding out in any way as carrying on such a business, but excluding persons set out in MLO Sch 1 Part 1, or, in respect of the loans set out in MLO Sch. 1 Part 2, those persons who make such loans. As for the definition of "loans," see further MLO s. 2(1).

[38] *Ibid*., see s. 7. The role of Registrar of Money Lenders is currently performed by the Registrar of Companies. The Licensing Court is responsible for determining applications for and grant of money lenders licences.

[39] *Ibid*., see s. 12 (effect and duration of licence) and s. 13 (renewal).

[40] *Ibid*., see s. 9 (investigation and lodgement of complaints), s. 11 (determination of application for licence) and s. 14 (revocation and suspension of licence).

[41] *Ibid*., s. 23.

[42] *Ibid*., see for example s. 21 (no restrictions on early repayment by borrower), s. 22 (restrictions on compound interest, prohibition of repayment by instalments and charging of increased default interest), s. 24 (prohibition of excessive interest rates) and s. 27 (prohibition of any charges or expenses).

[43] *Ibid*., s. 24(2) (regarding interest rate that exceeds 60% per annum) and s. 25(1) (regarding interest rate that exceeds 48% per annum).

[44] In *China Merchants Bank v. Minvest Int'l Ltd.*, Doc. 9070/2000, [2001] H.K.E.C. 2060 (H.C.A.), where PRC law was chosen as the governing law of the loan contract, the lender suggested that the MLO does not intend to supervise and regulate money lending activities outside Hong Kong. This case was appealed but the issue was not further considered on appeal (see Doc. 2960/2001, [2002] H.K.L.R.D. (Yrbk) 217 (C.A.)).

[45] See Brian Gilchrist, ed., *Chitty on Contracts: Hong Kong Specific Contracts,* 6th ed. (Hong Kong: Sweet & Maxwell, 2019) at 9-024 [Gilchrist].

If the loan contract contains any clause trying to disapply the MLO, it should be an immediate warning sign for any prospective borrower that the lender is dubious.

(vi) Hairline default triggers

Another common feature of predatory commercial loans is the hairline triggers for borrower defaults. Borrowers are typically not granted any grace period to rectify any defaults (even if these are trivial technical defaults which can be easily rectified). There is also no allowance for *de minimis* thresholds to avoid trivial defaults. Any default by the borrower would give the lender an excuse to charge hefty default interest rates and to keep the borrower's collateral.

The loan contract often contains clauses that allow the lender to charge exorbitant additional default interest rates if the borrower defaults. Such default interest will usually start to accrue from the date of the borrower's default, regardless of whether the borrower was aware of such default or not.

We have seen situations where, after collecting the borrower's collateral, the predatory lender ceases communication with the borrower. If that happens, the borrower would be in a dilemma whether to continue repaying its debt obligations on the loan. If the borrower stops paying, the lender would have an immediate excuse to call default, charge hefty default interest, and the borrower would be at risk of losing its collateral. However, if the borrower continues to repay its debt obligations, there is no guarantee that it would be able to redeem the collateral if the lender is incommunicado.

It could take the borrower many months or years before realizing this. By which time, the borrower would not only have lost its collateral assets, it would also have lost the loan repayments that it has diligently made to the lender.

(vii) Re-hypothecation and shortselling

Borrowers that hold substantial listed securities may be concerned about their securities being lent to short-sellers to "short" the securities, or being directly dumped into the market to short the securities. Securities that are especially vulnerable to short-selling are those that have a low daily trading volume, because a relatively small amount of the securities being dumped into the market could have an exponential impact on the price of the securities, especially by triggering stop loss orders and eventually create panic selling of that stock.[46]

To give the borrower some comfort, predatory loan contracts may contain provisions that restrict short-selling activities. However, such clauses may be intentionally drafted ambiguously. One approach would be for the lender to give

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[46] See Gil Morales & Chris Kacher, *Short-Selling with the O'Neil Disciples: Turn to the Dark Side of Trading* (Hoboken, New Jersey: John Wiley & Sons, 2015), at c. 2. Generally, the thinner the stock, the greater and faster the potential movement in the stock. However theoretically, there is some price velocity risk with thinner stock, in that the stock may suddenly begin to push higher under a stock squeeze situation.

broad representations to the effect that it is not directly engaged in short-selling activities, instead of a direct positive undertaking by the lender to not engage (directly or indirectly) in such activities. In practice, it also is not easy to know if (and even more difficult to prove that) the lender has breached the anti-short selling undertaking. Predatory loans are also usually structured in a way that is very difficult for the borrower to enforce (which we will discuss further below).

(viii) Margin calls

Predatory commercial loan documents often contain strict margin call provisions. Under a typical margin call arrangement, the lender specifies a maintenance requirement which is triggered if the market value of the collateral falls below a certain price. When the collateral falls below this value, a margin call occurs, whereby the borrower must deposit new funds or further securities to make up for the decrease in market value of the collateral, or repay a certain portion of the loan.[47] Failure by the borrower to comply with margin call obligations would result in a borrower default, which would entitle the lender to charge hefty default interest and enforce against the collateral.

Margin call provisions are not unusual — they give lenders the right to require margin top-ups from the borrower if the market value of the collateral falls. However, when coupled with the ability to short-sell the securities (which will push down the market value of the securities), this becomes a formidable combination, which will almost always ensure that the borrower will never be able to redeem its collateral.

(c) Enforcement Challenges for the Borrower

Many borrowers think that only lenders will be concerned about the ability to enforce a loan contract. However, it is equally important for the borrower to be able to enforce the loan documents, especially when it has transferred its valuable collateral to the lender. Unfortunately, most borrowers fail to pay attention to this. This section highlights some common features in predatory commercial loans that create enforcement challenges for borrowers.

(i) Dubious lenders

Predatory lenders are usually without any established lending track record in Hong Kong or elsewhere. They will not be regulated by any government authority, regulator (such as a banking or securities regulator) or the police (in the case of licensed money lenders).

The lender will usually be incorporated in an exotic location (such as Nevis, Seychelles, Gibraltar, Marshall Islands, etc.), where it is relatively more difficult to conduct public searches to obtain information about the lender's board of directors, its shareholders, its standing, its litigation records, its assets, etc.[48]

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[47] See Konan Chan et al., "Share pledges and margin call pressure" (2018) 52 J. Corp. Fin. 96.

For example, in the *Keyway Holdings* case,[49] it was discovered that no company in the name of the lender was incorporated or registered in the Republic of Seychelles. It was only after obtaining a mandatory disclosure order against the securities intermediary which holds the collateral on behalf of the lender, that the "true" identity of the lender was revealed.

(ii) Governing law

Predatory lenders may choose a governing law that appears to be well-established and neutral. Hong Kong law is a typical choice of governing law.[50]

However, the unsuspecting borrower may not be aware that predatory lenders choose jurisdictions that have less easy access to legal services as their choice of governing law in loan contacts. This makes it more expensive and harder for borrowers to take legal action.

Generally, Hong Kong does not allow conditional fee arrangements for legal services. A conditional fee arrangement is an agreement between a legal practitioner and his/her client, to the effect that the legal practitioner will charge no fees if the client's court case is conducted unsuccessfully. In Hong Kong, lawyers are prohibited from entering into conditional fee agreements to act in contentious business.[51]

In addition, third-party litigation funding is also generally prohibited for litigation in the Hong Kong courts.[52] The rules of champerty and maintenance in Hong Kong prohibit any party without a legitimate interest in the action from

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[48] Such jurisdictions usually do not provide easily accessible public registers. For example, the Gibraltar Companies House requires a user to first apply for an online account, before its e-Registry services may be used. Otherwise, one may have to attend the Companies House in person to obtain relevant search results. In the Marshall Islands, there is no requirement for the names of corporate officers, directors or shareholders to be filed in the public registry.

[49] To be further discussed in the section titled "Recent Case Studies" below.

[50] Under the Basic Law of the Hong Kong Special Administrative Region (Basic Law) and Hong Kong Reunification Ordinance (Cap 2601) s. 7, the laws in force in Hong Kong prior to 1 July 1997 (i.e. English common law, rules of equity, ordinances, subordinate legislation and customary law) shall be maintained, insofar as it does not contravene the Basic Law (subject to any amendment by the legislature in Hong Kong). Accordingly, English judicial authority prior to 1 July 1997 is generally binding on Hong Kong courts. English judicial authority on or after 1 July 1997 and those of other common law jurisdictions are persuasive, but not binding, on Hong Kong courts.

[51] See Legal Practitioners Ordinance (Cap 159) s. 64(1); Hong Kong Solicitors' Guide to Professional Conduct principle 4.16; Conduct for the Bar of Hong Kong para. 124. See also *Cannonway Consultants Ltd. v. Kenworth Engineering Ltd.*, [1997] A.D.R.L.J. 95 per Kaplan J. at 95-105.

[52] There are narrow exceptions. For example, Hong Kong courts will permit an assignment of a cause of action by a liquidator of an insolvent estate (*In re Cyberworks Audio Video Technology Ltd.*, [2010] 2 H.K.L.R.D. 1137). Another example is arbitration funding, which is expected to be permitted under the Arbitration and Mediation Legislation (Third Party Funding) (Amendment) Ordinance 2017 (however, note that some provisions of this Ordinance are not yet in force at the time of writing).

assisting or encouraging a party to that action in return for a share in the proceeds if the claim succeeds.[53] Breach of such rules may even be punishable under section 101I of the Criminal Procedure Ordinance (Cap 221) by imprisonment and fine.

Unlike jurisdictions such as the US or the People's Republic of China (PRC) where such arrangements are allowed and common,[54] which in turn provides litigants with alternative financing sources to fund the legal costs for their cases, any borrower wanting to take legal action against a lender in Hong Kong will need to be able to finance its own legal expenses. This creates the first major hurdle for the borrower.

(iii) Mandatory negotiation clauses

Predatory loan contracts may also impose a mandatory "all reasonable endeavours" or "best endeavours" negotiation requirement before commencing arbitration. Such provisions are not unusual and are generally enforceable under Hong Kong law.[55] However, such negotiation provisions may have no prescribed time limit, making it difficult for the borrower to know how long it must negotiate before commencing arbitration proceedings. To add further ambiguity, some negotiation clauses do not specify an end date to negotiations, and hence in theory could continue indefinitely (subject to the requisite level of endeavours having been agreed upon).[56] To increase the difficulty of compliance, there may be procedural steps required to be taken by the borrower or the lender to commence negotiation, for example having to serve a notice of negotiation on the other party within a certain number of days when the dispute has arisen.

This requirement effectively alerts the lender of the borrower's intention to commence legal action. A rogue lender may start to dissipate its assets and cover its tracks in order to frustrate the borrower's enforcement options.

Another difficulty with complying with this negotiation obligation arises when the lender has simply disappeared or is uncontactable. Failure to properly comply with this requirement could affect the enforceability of an arbitration

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[53] In the context of the Hong Kong legal profession, see *Winnie Lo v. HKSAR* (2012), 15 H.K.C.F.A.R. 16 (C.F.A.); *HKSAR v. Mui Kwok Keung*, [2013] H.K.E.C. 610 (C.F.I.); [2014] 1 H.K.L.R.D. 116 (C.A.).

[54] For an analysis of jurisdictions which permit conditional fee arrangements, as compared to Hong Kong, see Law Reform Commission of Hong Kong, *Consultation Paper on Conditional Fees* (September 2005), online: <https://www.legco.gov.hk/yr05-06/english/panels/ajls/papers/aj1024cb2-conditional-e-scan.pdf>.

[55] *Wah (aka Alan Tang) v. Grant Thornton International Ltd.*, [2012] E.W.H.C. 3198 (Ch.). See also *Emirates Trading Agency LLC v. Prime Mineral Exports Private Ltd.*, [2015] 1 W.L.R. 1145, which enforced a 4-week friendly discussion obligation.

[56] English case law suggests that "all reasonable endeavours" requires parties to do what a reasonably competent and energetic person in the circumstances would do; while "best endeavours" requires parties to "leave no stone unturned". See *CEP Holdings Limited v. Steni AS*, [2009] E.W.H.C. 2447; *Sheffield District Railway Co. v. Great Central Railway Co.*, [1911] 27 T.L.R. 4512.

award later on.[57] Such provisions serve to create an additional challenge for borrowers desperately trying to recover their collateral.

(iv) Choice of arbitration

Predatory commercial lenders usually prefer arbitration as the forum for dispute resolution (instead of using the courts).

Arbitration has grown to become a popular dispute resolution method around the world, especially in Hong Kong. Hong Kong prides itself as an arbitration centre and has a clear pro-arbitration policy among the government, legislature and courts.[58]

However, arbitration may create a barrier to taking insolvency winding-up action against a lender. If a lender defaults in returning the borrower's collateral without any credible defence (which may suggest that the lender is unable to pay its debts), the borrower may petition to the court to put the lender into insolvency, and appoint insolvency trustees to take over the lender's estate and investigate the lender's dealings as soon as possible. Time is of the essence if the borrower is to have any hope to stop any dissipation of its collateral (or the proceeds from the sale of such collateral). However, a rogue lender facing an insolvency petition may use arbitration as an excuse to stay the winding up proceedings and insist for the dispute to be referred to arbitration before the winding up petition can be proceeded by the court.[59]

(v) Service of court proceedings or arbitration notice

In Hong Kong, in order to commence court action against any party outside Hong Kong, it is generally necessary to obtain permission from the Hong Kong court.[60] This need for permission causes unnecessary delays and increases legal costs, and such permission is not automatically granted. It may also create unnecessary hurdles where urgent injunctions are sought.

This hurdle could easily be avoided if the lender appoints a Hong Kong process agent in the loan contract.[61] However, it is unusual and not market practice for lenders to appoint process agents (whereas it is common for non-

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[57] See Gilchrist, *supra* note 45 at 2-012-2-013.

[58] See Department of Justice, The Government of the Hong Kong Special Administrative Region, *Legal and Dispute Resolution Services — Arbitration*, online: < https://www.doj.gov.hk/en/legal_dispute/arbitration.html > .

[59] See Kingsley Ong, Wesley Pang & Justin Bong-Kwan, "The Intersection of Arbitration and Insolvency in Hong Kong: The Court's Discretion in Winding-Up Proceedings" in Alan Gibb, Richard Morris, & King Fung Tsang, eds., *An Introduction to the Conflict of Laws in Hong Kong*, 2nd ed. (Hong Kong: Lexis Nexis, 2020) at c.11.

[60] See R.H.C. Ord 11. This assumes the entity has no presence in Hong Kong, by way of registration as a non-Hong Kong company with the Hong Kong Companies Registry or otherwise recognised under Hong Kong law.

[61] See R.H.C. Ord 10 r. 3. Generally speaking, service of writ in pursuance of a contract is good service where the court has jurisdiction to hear and determine any action in respect of that contract, whether such jurisdiction is conferred on the court by a term in the

Hong Kong borrowers to be required to do so).[62] There may also be a cost to appoint a process agent, and most borrowers will not insist on this reqirement for the lenders in order to save costs (as such costs are usually passed back to the borrowers).

Similar challenges exist for commencing arbitration proceedings. If arbitration proceedings are commenced and proceeded without the lender's knowledge, the lender may try to further delay enforcement proceedings later on by claiming a breach of natural justice in that it did not have a chance to present its defence.

3. RECENT CASE STUDIES

Given the difficulties for borrowers as highlighted above, not many predatory commercial loan cases end up in court. In this section, we have sought to provide some examples of reported cases with predatory features discussed in this article.

(a) UK Case Law

In *Battlebridge Group Ltd. v. Amala Equity Ltd.*,[63] the lender, a company incorporated in Gibraltar, extended a non-recourse loan in the total sum of £3.69 million to the borrower in January 2004, secured against the borrower's 5,493,708 shares in an AIM listed company,[64] 3DM Worldwide Plc (3DM). The LTV of the loan was 40% of the value of the collateral shares. Under the terms of the non-recourse loan agreement, the 3DM shares were to be placed and remain in a designated account, presumably under the name of the lender. The lender was under an obligation not to deal with the 3DM shares, save to the extent of establishing its credit line for financing the loan. However, the lender failed to advance the funds to the borrower even by end of April 2004. The lender and the borrower reached an agreement after negotiation, whereby it was agreed that £2 million would be advanced by the lender immediately, with the balance to be advanced two months after and that the collateral would be reduced to 493,708 3DM shares only. It was later discovered by the borrower in early July 2004, that the lender had disposed of 60,000 3DM shares in March 2004 for gain, and that 5

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contract or is assumed by the court apart from such contract. However, note special rules in relation to service out of jurisdiction.

[62] This one-way only appointment of process agent by borrowers (and not lenders) is also reflected in the market standard APLMA and LMA loan facility documentation. See LMA: <https://www.lma.eu.com/documents-guidelines/documents> and APLMA: <https://www.aplma.com/documentation> (access available only to members).

[63] *Battlebridge Group Ltd. v. Amala Equity Ltd.*, [2006] All E.R. (D.) 324 (Nov), [2006] E.W.H.C. 2982 (Comm).

[64] AIM is the London Stock Exchange's international market for smaller growing companies, launched in 1985.

million 3DM shares were transferred out of the designated account to another account maintained with a different securities intermediary.

The lender argued that the parties had reached an agreement, whereby payment of the remainder of the loan in the amount of £1.69 million was to be made subject to satisfactory checks conducted by the lender on 3DM. The court held that the condition for payment of the remainder of the loan did not exist. In relation to the disposal of 60,000 3DM shares, the court held that since they were sold before any advance had been made by the lender or any interest being accrued, the borrower is entitled to the value of the 3DM shares converted.

Although the borrower was successful in enforcing its claims against lender misconduct, various difficulties were encountered:

(a) The lender was a company incorporated in Gibraltar and shared the same name as another company incorporated in Ireland. Neither companies have ever traded. Both companies maintained bank accounts but with no assets. In this case, the borrower was fortunate to be able to apply to the English court to add both the controlling person (who was the sole shareholder and sole executive director of both companies) and the Irish company as defendants in the action (even though these were not parties of the loan contract). If the borrower was not able to add the controlling person as a defendant to the action, the borrower may have been left with an empty shell company to enforce against.

(b) Since 5 million 3DM shares remained in the designated account, the borrower had to seek a court injunction to stop the lender from transferring those shares away. It is unknown whether the 5 million 3DM shares were ever transferred back to the borrower.

(c) Preliminary judgment took more than two years (after the loan agreement was entered into).The 60,000 3DM shares sold were unrecoverable by the borrower.

(b) US Case Law

(i) Argyll Equities

Various enforcement actions were lodged by borrowers against Argyll Equities, LLC (Argyll), a limited liability company incorporated in the US state of Texas, which appeared to operate a business advancing loans secured by pledges of shares.[65]

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[65] Share pledges are recognised under US law. A pledge under US law is a bailment of personal property for the purpose of securing a loan or other obligation, and stock or shares can be the subject of a pledge. See Ray Andrews Brown, *The Law of Personal Property*, 3rd ed. (Chicago: Callaghan, 1975) at 15.1.

In *Siko Ventures v. Argyll Equities, LLC*,[66] Siko Ventures (Siko), the borrower, sought recognition and enforcement by the US court of a judgment rendered by the Hong Kong court against Argyll. Argyll advanced certain funds to Siko against Siko's pledge and transfer of shares it owned in a company listed on the Hong Kong Stock Exchange. However, Argyll failed to advance any funds to Siko in accordance with the loan agreement and sold a portion of the pledged shares. Siko sued Argyll in the Hong Kong court to restrain Argyll from selling additional pledged shares, and to recover the remaining pledged shares. Argyll argued that it was not properly served with the writ of summons and that the loan and pledge agreements provided for exclusive jurisdiction and venue of any dispute in the courts of Kendall County, Texas. The Hong Kong court held in favour of Siko, entering final judgment ordering Argyll to, *inter alia*, pay Siko proceeds and profits from the disposition of pledged shares. In the proceedings before the Texas court, Argyll argued, *inter alia*, that the Hong Kong court had no personal jurisdiction over Argyll, and that the Hong Kong proceedings were contrary to the forum selection clause in the loan and pledge agreements. The Texas court rejected these arguments, finding that Argyll had voluntarily submitted to the jurisdiction of Hong Kong by contesting before the Hong Kong court and that the forum clause in the loan and pledge agreement were permissive only.[67]

In *Argyll Equities, LLC v. Servicios Directivos Servia S.A. de C.V.*,[68] Argyll advanced funds under a series of loans to Servicios Directivos Servia S.A. de C.V. (SDS), the borrower, against a pledge of shares held by SDS in a company listed on the New York Stock Exchange. The loan agreement stated that SDS may not repay the loans for the first 18 months, and thereafter, it must give Argyll 30 days' notice of its intent to prepay if SDS elects to repay the loans before their maturity dates. Argyll is obliged to return the pledged stock within 10 days of repayment. However, the loan agreement did not provide a legal right for Argyll to sell the pledged collateral. Argyll sold the pledged shares anyway, and SDS successfully obtained partial summary judgment and a pre-judgment writ of attachment[69] against Argyll in the trial court. However, the grant of a pre-judgment writ of attachment was overturned by the appeal court. Specifically, the appeal court held that the outstanding indebtedness of Argyll

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[66] *Siko Ventures v. Argyll Equities, LLC*, 2005 U.S. Dist. LEXIS 21257, 2005 WL 2233205 (W.D. Texas, Div. San Antonio, 2005).

[67] The relevant portion of the clause reads "[Siko] submits to the non-exclusive jurisdiction of all Federal and State Courts sitting in Kendall County". This could be contrasted with the case of *Argyll Equities LLC v. Paolino*, 211 Fed. Appx. 317 (5th Cir., 2006), where the forum selection clause incorporating the phrase "exclusive jurisdiction of the courts sitting in Kendall County, Texas" was held to have made such venue mandatory.

[68] *Argyll Equities, LLC v. Servicios Directivos Servia S.A. de C.V.*, 227 S.W.3d 268 (Tex. App., San Antonio, 2007); Doc.06-261 CCL (Texas Kendall County).

[69] A prejudgment writ of attachment operates by way of a security interest on the property of the defendant, providing a source of financial recovery for a plaintiff. It is usually filed to secure debts or claims of the creditor in the event a judgment is rendered.

to SDS could not be ascertained, since this depends on when and whether SDS repays each loan, and the pledged share's value at the relevant time. SDS also failed to demonstrate that there was a high chance Argyll could not satisfy any judgment that may be rendered against it since SDS only had access to Argyll's internally prepared balance sheet and anecdotal evidence that Argyll is moving assets offshore.

(ii) Derivium Capital

There were several court decisions relating to the question of whether the transactions between Derivium Capital, LLC (Derivium) and its borrowers should be characterized as a "loan" or a "sale of securities", which in turn affected its tax code treatment under US law.[70] Nonetheless, the facts from these cases demonstrate some of the risks for borrowers.

In *Calloway v. Commissioner*,[71] Derivium advanced funds to Mr. Calloway, a former employee of International Business Machines Corporation (IBM) which is listed on the New York Stock Exchange, on a non-recourse basis against a pledge of his IBM shares. Derivium offered to lend Mr. Calloway 90% of the purchase price at an interest rate of about 10% for a three-year term, and neither the principal nor interest would be required or permitted to be paid before maturity. There was further an option for renewal of the loan for a further term of three years. The pledge agreement provided Derivium with a right to sell the IBM shares at any time, though Derivium orally represented it had a hedging strategy against the IBM shares, and that it would not sell the stock absent a default by Mr. Calloway. However, Derivium simply sold the pledged IBM shares into the market the day after it received the same from Mr. Calloway. Derivium effectively bought Mr. Calloway's shares for 90% of its fair market value but sold it for its full fair market value.

In *Clark v. United States*,[72] the borrower, Mr. Clark, transferred a loan obtained from a bank along with the accompanying collateral, being Floating Rate Notes (FRNs), to an affiliate of Derivium, in consideration of Derivium advancing certain loans to Mr. Clark. The loans advanced by Derivium were non-callable, non-recourse, with no margin requirement, and a highly restricted payment to the principal and interest during the term of the loans. Derivium represented to Mr. Clark that the transaction was a loan, and interest payment

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[70] See *United States v. Cathcart, et. al.*, 2009 U.S. Dist. LEXIS 86866, 2009 WL 3103653 (N.D. Cal., 2009). The gist of the tax treatment debate is whether any gains or dividends received on the pledged stock need to be reported by the borrower, given that the stock was pledged in accordance with a non-recourse loan agreement, and that the stock had been sold by the lender.

[71] *Calloway v. Commissioner*, 691 F.3d 1315, 2012 U.S. App. LEXIS 17892, 2012-2 USTC P 50,533, 110 A.F.T.R.2d 2012-5661, 23 Fla. L. Weekly Fed. C 1462 (11th Cir., 2012). For a further analysis of the case, see Matthew A. Stevens, "Of Ponzi Schemes and Nonrecourse Loans: A. L. Calloway" (2011) 9:2 J. Tax'n Fin. Prod. 13.

[72] *Clark v. United States*, 2012 U.S. Dist. LEXIS 181928, 2013-1 USTC P 50,119, 111 A.F.T.R.2d 2013-344, 2012 WL 6709624 (N.D. Cal., Div. San Francisco, 2012).

on the loan will be offset by interest paid on the FRNs. The loan agreements provided that Derivium is free to sell or otherwise dispose of the FRNs, and enjoy the right to receive and retain the benefits on the FRNs, during the term of the loans. However, the loan agreements also provided that Derivium shall return the same collateral, adjusted for equities, any and all kinds of stock splits, conversions, exchanges, mergers or other distributions, to Mr. Clark at the end of the loan term. It turned out that Derivium sold the FRNs, including their principal and interest, on the open market.

It is helpful to note that in both the *Derivium* cases mentioned above, the court held that legal title to the collateral had been transferred to Derivium by way of the pledge of collateral.[73]

(c) Hong Kong Case Law

In *Asia-Pacific Infrastructure Investment Fund, LP v. Keyway Holdings Ltd.*,[74] the lender, a Seychelles-incorporated company, extended a non-recourse loan to the borrower against the borrower's transfer of its shares in a company listed on the Hong Kong Stock Exchange as collateral and security. The shares were deposited into an account opened in the borrower's name, but subject to the instructions of the lender. It subsequently transpired that the number of these shares recorded or evidenced by CCASS[75] records had fallen, meaning the lender had transferred away some of the shares. The borrower faced difficulties in service of process on the lender when it discovered the Seychelles-incorporated company in fact did not exist. Nonetheless, the borrower was able to locate and join the Hong Kong entity of the lender to the action, and successfully sought a mandatory injunction for partial replenishment of the shortfall in collateral, a prohibitory injunction restraining further disposal of the collateral, and a disclosure order for documents evidencing whereabouts of the collateral transferred away.

In *L. v. B.*,[76] the lender advanced a non-recourse loan to the borrower against the borrower's transfer of his shares in a company listed on the Hong Kong Stock Exchange as collateral and security. The borrower duly transferred his shares to the lender, but the lender failed to extend the full amount of the loan as agreed. The lender further sold some of the shares which had been transferred to it by the borrower. The loan agreement contained an effective mandatory

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[73] Please note the difference in treatment of shares/bonds pledge under English and US law. The former does not recognise a pledge of non-documentary shares/bonds, and would likely treat such a transaction as a mortgage or charge of shares/bonds. Therefore, whether legal title to the collateral had been transferred to Derivium by way of the shares/bonds pledge under English law, may well lead to a different conclusion.

[74] *Asia-Pacific Infrastructure Investment Fund, LP v. Keyway Holdings Ltd.*, [2018] H.K.C.F.I. 2228.

[75] CCASS, or the Central Clearing and Settlement System, is the central clearing and settlement system used by all market participants in the Hong Kong Stock Exchange.

[76] *L. v. B.*, [2016] H.K.E.C. 1100.

arbitration clause, and the borrower had to go through an arbitration in the Bahamas for an arbitral award before he could proceed with enforcement actions in Hong Kong. Because the lender commenced parallel proceedings in the Bahamas court to challenge the validity of the arbitral award, the borrower was obstructed from proceeding with immediate enforcement of the award in the Hong Kong court.

In *Wason Holdings Ltd. v. BHP International Markets Ltd.*,[77] the lender, a company incorporated in the Bahamas, advanced a non-recourse loan to the borrowers against the borrowers' transfer of their illiquid shares (i.e. shares with low daily trading volume) in a company listed on the Hong Kong Stock Exchange. The borrowers believed that the shares would be retained by the lender, and would be returned to them upon full repayment of the loan. However, the lender argued that its business model requires it to sell or deal with security at any time, so as to generate sufficient funds to enable it to make further loans to other borrowers. The lender also disputed the version of the loan agreement that the borrowers were relying on, claiming it was not the final version that was agreed between the parties. The borrower was able to obtain a prohibitory injunction against the lender for disposing the proceeds of sale, and a disclosure order for documents evidencing whereabouts of the collateral sold. However, both court orders were overturned following a successful appeal by the lender.

In *Quaestus Capital Pte Ltd. v. Everton Associates Ltd.*,[78] Everton Associates Ltd (Everton) advanced certain non-recourse loan to the borrower, in an amount of around 52% of the market value of certain Hong Kong listed company shares collateral, to be provided in tranches and secured by a pledge of the collateral shares. Everton undertook not to liquidate or shortsell the collateral shares. Under the financing terms, if the market price of the listed shares is less than 50% of the market price for the trading day preceding a funding date or 90 trading days after a funding date, this will constitute an event of default. Furthermore, Everton had a right to hypothecate the collateral, as a "portfolio protection arrangement." Everton originally nominated a Hong Kong-based intermediary brokerage firm to hold the collateral shares in custody, however, it claimed that due to bank compliance matters in Austria, it was unable to wire out the 1st tranche of the loan, and requested the borrower to open an account with another brokerage firm, Axis Capital Markets Ltd (Axis), to expedite matters. The borrower then duly transferred the collateral from the Hong Kong-based brokerage firm to Axis, and entered into a tri-partite custodian agreement with an exclusive London jurisdiction clause, between Axis, Everton and the borrower. It was discovered that shortly after the transfer, Everton/Axis entered into a credit agreement and hypothecation agreement with a financial institution

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[77] *Wason Holdings Ltd. v. BHP International Markets Ltd.*, [2018] H.K.C.A. 113 (C.A.), [2015] H.K.E.C. 453 (C.F.I.). The case appears to be ongoing as of the time of writing.

[78] *Quaestus Capital Pte Ltd. v. Everton Associates Ltd.*, [2021] H.K.C.F.I. 1367 (C.F.I.). The case appears to be ongoing as of the time of writing.

in Hong Kong, who lent the collateral to a Belize-incorporated company, which in turn sold the collateral shares in the public market, the proceeds of which were used to purchase securities for hypothecation to another account holder with Axis. Around the same time, the collateral share price fell dramatically, triggering the market price event of default under the financing terms. Everton, without having advanced any tranche of the loan, issued an event of default notice to the borrower, alleging that it had the right to deal with the collateral as their sole and absolute owner. The borrower claimed that Everton, Axis, the Hong Kong financial institution and the Belize-incorporated company carried out a fraudulent scheme to deprive it of the collateral shares. Everton argued in defence that it had the right to enter into the hypothecation agreement, and requesting the court to declare an event of default having occurred; on the other hand, Axis challenged whether the Hong Kong court had jurisdiction over this case, and claimed that it was only acting on instructions of Everton in accordance with the tri-partite custodian agreement. The borrower succeeded in obtaining the Hong Kong court's recognition of jurisdiction over Axis in the proceedings, notwithstanding the exclusive London jurisdiction clause, and obtained an order for service of the writ out of jurisdiction.

In *Binchuang Resources Co. Ltd. v. Lockwood Group Ltd.*,[79] the lender, Lockwood Group Limited (Lockwood), advanced certain loans to the borrower of up to RMB40 million secured by a pledge of 30 million shares of a Hong Kong listed company. The collateral shares were to be deposited with an intermediary brokerage firm, Axis Capital Markets Limited (Axis), under the terms of a tripartite collateral agency agreement. Under the financing terms, Lockwood is restricted from dealing with the collateral shares, and cannot transfer the collateral prior to an event of default. Following deposit of the collateral shares with Axis, Lockwood advanced RMB690,900 as a "test tranche" to "make sure the disbursement process works" — however, it failed to make any further loan advancements. The borrower became concerned with the whereabouts of the collateral shares, and sought and obtained a disclosure order against Lockwood and Axis — it was discovered that the collateral shares were transferred away from the custodian account not long after the borrower deposited the same with Axis, and that Lockwood had sold or disposed of the collateral shares with the knowledge and assistance of Axis. The borrower then instituted a claim against Lockwood and the intermediary brokerage firm, alleging their: (i) fraudulent misrepresentation of a genuine ability to advance loans to the borrower; (ii) breach of trust in that the borrower had a proprietary interest in the collateral shares; (iii) breach of contract for failing to advance the loans and improper dealing with the collateral shares; and (iv) unlawful means conspiracy defrauding the borrower. Lockwood argued in defence that the overall arrangement was not a security arrangement and hence it had rights to dispose and use the "collateral" shares, as a portfolio protection arrangement, and that it had made loan

[79] *Binchuang Resources Co. Ltd. v. Lockwood Group Ltd.*, [2022] H.K.C.F.I. 739 (C.F.I.). The case appears to be ongoing as of the time of writing.

advances to the agent who introduced the borrower to it. The borrower applied for interim payment against Lockwood on the basis of its actions. The Hong Kong court awarded a direct interim payment of approximately HK$54 million payable by Lockwood within 56 days.

Despite some successes by borrowers to obtain recourse, injunctions and other interlocutory remedies against rogue lenders, enforcement of the borrower's rights is costly, time-consuming and rarely straightforward.

4. CONCLUSION

At first sight, particularly for borrowers who have struggled to get funding elsewhere, a loan, especially with non-recourse features, is a dream "too good to be true." However, borrowers must be careful to protect the return of their collateral against potential lender defaults. Otherwise, this could become a borrower's worst nightmare.

In our article, we have highlighted some features that borrowers should pay attention to when reviewing loan documents and conducting diligence on their prospective lenders. Predatory commercial loan agreements have various mechanisms that could confuse unwary borrowers. Borrowers that fall into predatory loan traps often struggle to recover their collateral assets. Even when such borrowers want to take legal action, the legal process can be costly and arduous, with no guarantee of success.

Borrowers would be well-advised to at least consider the below minimum checklist for their own protection:

(a) Conduct proper due diligence on the lender. Borrowers should check if their lender is duly incorporated and validly existing in its jurisdiction of incorporation, verify who are its directors and shareholders, conduct basic "know your customer" checks on the directors (including checking and taking copies of their original passports and identification documents). Do not rely on promoters or broker-dealers who connect the lender, as they may not have vetted the lender themselves.[80]

(b) Insist on the collateral (especially for negotiable securities) to be deposited with a reputable third party (unconnected to the lender) as escrow custodian, with a clear escrow agreement signed by all parties (including the third-party escrow custodian), to ensure that the lender cannot get access to the collateral when the borrower is diligently performing its loan obligations.

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[80] See for example *Li Kwok Heem John v. Standard Chartered International (USA) Ltd.*, [2016] 1 H.K.C. 535, where the bank introduced a customer to invest in a fund that turned out to be a fraudulent investment scheme, and the customer claimed that the bank made false representations in case of the investment. The fact that the case was ultimately decided in favour of the bank, demonstrates the difficulty in which a prospective borrower may have alternative recourse against the broker-dealer intermediary.

(c) Obtain legal opinions from legal counsel in the applicable jurisdictions, to confirm the lender's background, capacity, authority and due execution of the loan documents, before transferring any collateral.

A genuine lender who is sincere in returning the borrower's collateral assets upon repayment of the loan, and with no intention of shorts-selling the securities, should have no difficulty in accepting the above requirements.

Even with the best precautions, there will always come a stage when borrowers under excessive debt pressures will become trapped and succumb to accept predatory loans. The only way for borrowers to properly escape the imminent convergence of economic crises is to reduce excessive debt.