THE LENDING AND SECURED FINANCE REVIEW

SEVENTH EDITION

Editor
Azadeh Nassiri

THE LAWREVIEWS

THE LENDING AND SECURED FINANCE REVIEW

SEVENTH EDITION

Reproduced with permission from Law Business Research Ltd
This article was first published in July 2021
For further information please contact Nick.Barette@thelawreviews.co.uk

Editor
Azadeh Nassiri

THE LAWREVIEWS

PUBLISHER
Clare Bolton

HEAD OF BUSINESS DEVELOPMENT
Nick Barette

TEAM LEADERS
Jack Bagnall, Joel Woods

BUSINESS DEVELOPMENT MANAGERS
Katie Hodgetts, Rebecca Mogridge

BUSINESS DEVELOPMENT EXECUTIVE
Olivia Budd

RESEARCH LEAD
Kieran Hansen

EDITORIAL COORDINATOR
Gavin Jordan

PRODUCTION AND OPERATIONS DIRECTOR
Adam Myers

PRODUCTION EDITOR
Martin Roach

SUBEDITOR
Krystal Woods

CHIEF EXECUTIVE OFFICER
Nick Brailey

Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK

www.TheLawReviews.co.uk

ISBN 978-1-83862-800-0

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ADVOKATFIRMAET BAHR AS

ALLEN & OVERY

ALUKO & OYEBODE

BREDIN PRAT

CMS PASQUIER CIULLA MARQUET PASTOR SVARA GAZO

DE BRAUW BLACKSTONE WESTBROEK

GOODMANS LLP

HENGELER MUELLER, PARTNERSCHAFT VON RECHTSANWÄLTEN MBB

LEE AND LI, ATTORNEYS-AT-LAW

LENZ & STAEHELIN

MORI HAMADA & MATSUMOTO

PAUL, WEISS, RIFKIND, WHARTON & GARRISON LLP

PEKİN & PEKİN LAW FIRM

PINHEIRO NETO ADVOGADOS

SLAUGHTER AND MAY

SYCIP SALAZAR HERNANDEZ & GATMAITAN

TRAVERS THORP ALBERGA

URÍA MENÉNDEZ ABOGADOS, SLP

WOLF THEISS RECHTSANWÄLTE/ATTORNEYS-AT-LAW

YKVN LLC

CONTENTS

PREFACE

This seventh edition of *The Lending and Secured Finance Review* contains contributions from leading practitioners in 21 different countries, and I would like to thank each of the contributors for taking the time to share their expertise on the developments in the corporate lending and secured finance markets in their respective jurisdictions, and on the challenges and opportunities facing market participants. I would also like to thank our publishers without whom this review would not have been possible.

I hope that the commentary that follows will serve as a useful source for practitioners and other readers.

Azadeh Nassiri
Slaughter and May
London
June 2021

Chapter 8

HONG KONG

Peter Lake[1]

I OVERVIEW

Hong Kong has an active bilateral loan market.

Syndicated lending is generally documented using the facility agreement forms prepared by the Asia Pacific Loan Market Association.

The main providers of finance are the Hong Kong-regulated financial institutions that have been authorised under the Banking Ordinance (Chapter 155 of the Laws of Hong Kong) as 'authorised institutions' to hold banking licences. Funds and private equity houses are more visible in bilateral bridge or other short-term bespoke financing arrangements.

2020 saw a decrease in syndicated and club loan volumes in the Asia-Pacific (excluding Japan), with a downturn of 14. 2 per cent year-on-year. This was attributable to the economic disruptions arising from the covid-19 pandemic. In contrast, financings for merger and acquisition-related activity in the region rose by 11.5 per cent due to two mega acquisitions. Charoen Pokphand's acquisition of UK supermarket chain Tesco's Thailand and Malaysian businesses involved a bridge loan of approximately US$7.24 billion; in Indonesia, Indofood Sukses Makmur's acquisition of instant-noodle manufacturer Pinehill Co Ltd was funded in part by a loan amounting to approximately US$2.05 billion.[2]

In 2020, Hong Kong's loan market totalled US$45.47 billion in volume, a decrease of 15.5 per cent year-on-year from the total of US$53.79 billion in 2019.[3] In 2020, the largest deal in Hong Kong was the Airport Authority Hong Kong's five year HK$35 billion loan facilities with 21 local and international banks.[4]

---

1 Peter Lake is a partner at Slaughter and May. The author would like to thank his colleague Adrien Yeung for her assistance in preparing this chapter.

2 'Debtwire: 2020 APAC (ex-Japan) Loans League Table Report', published by Asia Pacific Loan Market Association on 6 January 2021.

3 'Debtwire: 2020 APAC (ex-Japan) Loans League Table Report', published by Asia Pacific Loan Market Association on 6 January 2021.

4 'Debtwire: 2020 APAC (ex-Japan) Loans League Table Report', published by Asia Pacific Loan Market Association on 6 January 2021; https://www.hongkongairport.com/en/media-centre/press-release/2020/pr_1454#:~:text=(HONG%20KONG%2C%2023%20June%202020,tranche%20of%20the%20same%20amount.

II LEGAL AND REGULATORY DEVELOPMENTS

i Companies Ordinance

On 3 March 2014, a restatement of the Companies Ordinance (Chapter 622 of the Laws of Hong Kong) was brought into effect. Of particular note to lenders are the following changes:

a a reduction of the period to register charges with the Companies Registry. This period was reduced from five weeks to one month. The list of registrable charges was also amended and the underlying instrument of charge is now publicly available;

b financial assistance no longer resulting in underlying transactions becoming voidable (although it remains a criminal offence for the companies giving financial assistance). The exemptions from financial assistance have been broadened;

c changes to the terminology for financial statements;

d the abolition of the concepts of nominal share capital and premium, and of authorised share capital;

e the retirement of the memorandum of association; and

f an additional procedure for Hong Kong-incorporated companies to execute documents by way of deed but without affixing the common seal.

Lenders have expressed concern with respect to the clarification under the Companies Ordinance that charges over bank accounts are not charges over book debts (and so are not registrable under that head of registration). Lenders receiving security over bank accounts wish to protect their position by ensuring the bank account charge is registered at Companies Registry. In light of bank account charges not being registrable per se, the usual technique to register a bank account charge is to notify the Companies Registry that the bank account charge may be construed as a floating charge (as all floating charges are registrable under a separate head of registration).

With underlying instruments of charge now publicly available, the Companies Registry has stated it is now 'more important than ever' for lenders to make enquiries and search the Companies Register for charges. Although there is no Hong Kong case law on this point, the availability of the underlying instrument of charge will likely impact upon the issue of priorities between competing charge instruments.

ii Foreign Account Tax Compliance Act

Hong Kong has implemented the Foreign Account Tax Compliance Act (FATCA) Model 2 intergovernmental agreement. Although there remains variance in terms, as far as borrower risk is concerned, the market has moved towards a balanced position (namely that FATCA withholding is lender risk).

iii Basel III

Capital adequacy ratio

The Hong Kong Monetary Authority (HKMA) has issued rules (the Banking (Capital) Rules) under the Banking Ordinance (Chapter 155L of the Laws of Hong Kong), which prescribe in detail how the capital adequacy of locally incorporated authorised institutions should be calculated. These rules are based on the Basel III recommendations (which were implemented in Hong Kong on 1 January 2013).

A Hong Kong-incorporated authorised institution is required under the Banking (Capital) Rules to maintain a Common Equity Tier 1 capital ratio of at least 4.5 per cent, a

Tier 1 capital ratio of at least 6 per cent and a total capital ratio of 8 per cent. Branches of foreign banks are not subject to this requirement but, based on the HKMA's past practice of generally requiring any foreign bank that wishes to establish a branch in Hong Kong to maintain a capital adequacy ratio of at least 8 per cent, it is likely that the HKMA will continue to require foreign banks to meet the three minimum risk-weighted capital ratios.

Leverage ratio

Hong Kong-incorporated authorised institutions must also comply with the minimum leverage ratio set out in the Banking (Capital) Rules. The leverage ratio is a non-risk based measure of an authorised institution's capital adequacy, introduced as a 'back-stop' to restrict the build-up of excessive leverage in the banking sector and to provide an additional safeguard against model risk and measurement error in the risk-based capital adequacy ratios. The minimum leverage ratio is 3 per cent.

Capital buffers

In accordance with the Basel III recommendations, the HKMA may require a Hong Kong-incorporated authorised institution to have further capital buffers to cater for risks and uncertainties that are not already captured by the three minimum risk-weighted capital ratios that comprise the capital adequacy ratio. The HKMA has implemented the following capital buffers: the capital conservation buffer, the countercyclical capital buffer and (for domestic systemically important banks (D-SIBs)) the higher loss absorbency requirement.

The capital conservation buffer is an additional band of CET1 capital at 2.5 per cent.

The level of the countercyclical capital buffer is an additional band of CET1 capital that ranges from zero per cent to 2.5 per cent. The level is determined by the HKMA's analysis on whether there is excess aggregate credit growth associated with a build-up of system-wide risk in Hong Kong. It is an extension of the capital conservation buffer. On 28 January 2021, the HKMA announced the countercyclical capital buffer would remain unchanged at 1 per cent and noted that the economic environment in Hong Kong is subject to a high level of uncertainty.

The higher loss absorbency (HLA) requirement applies only to D-SIBs. It is also an additional base of CET1 capital that acts as an extension of the capital conservation buffer. The HLA range (where applicable) is normally between 1 per cent and 2.5 per cent, although there is a top range of 3.5 per cent. On 30 December 2020, the HKMA announced that Hong Kong's list of D-SIBs remains unchanged, covering six authorised institutions: The Hongkong and Shanghai Banking Corporation Limited, Bank of China (Hong Kong) Limited, Hang Seng Bank Limited, The Bank of East Asia, Limited, Industrial and Commercial Bank of China (Asia) Limited and Standard Chartered Bank (Hong Kong) Limited. Of the six banks, the HKMA has designated to The Hongkong and Shanghai Banking Corporation Limited the highest HLA (2.5 per cent for 2021) and to The Bank of East Asia, Limited, Hang Seng Bank Limited and Industrial and Commercial Bank of China (Asia) Limited the lowest HLA (1 per cent for 2021).

If a Hong Kong-incorporated authorised institution's capital level erodes to a level falling within the capital conservation buffer zone, the countercyclical capital buffer zone or, for a D-SIB, the HLA buffer zone, restraints will be imposed on that institution's distributions. A Hong Kong-incorporated authorised institution is expected to have a discussion with the HKMA if it anticipates that any of its capital levels will fall close to the buffer zones.

Loss-absorbing capacity rules

The Financial Institutions (Resolution) Ordinance (Chapter 628 of the Laws of Hong Kong) covers resolution, including bank resolution. On 14 December 2018, the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules were issued and came into operation. The Rules enable the HKMA to prescribe loss-absorbing capacity (LAC) requirements for 'within-scope' financial institutions that are Hong Kong-incorporated authorised institutions, and for their Hong Kong-incorporated holding companies or Hong Kong-incorporated affiliated operational entities. Not all Hong Kong-incorporated authorised institutions will be classified as 'within-scope' – meaning that not all of them will be subject to LAC requirements. The LAC consolidation group may differ from the regulatory capital consolidation group. The rules set out how to calculate LAC leverage ratios (both external and internal LAC, and under a solo, solo-consolidated and consolidated basis), capital component ratios and resolution component ratios (which will often be the same as the related capital component ratio). External LAC risk-weighted ratio will at a minimum be the sum of an authorised institution's capital component ratio and its resolution component ratio. Internal LAC risk-weighted ratio will be set at a fraction of the external LAC risk-weighted ratio (likely 75 per cent in most cases). There is a requirement for at least a specified portion (likely one-third) of the LAC to be in the form of LAC debt, as LAC debt (unlike LAC equity) is not at risk of depletion before bank failure and so provides a fixed quantity of financial resources that can support an orderly resolution. The rules also cover disclosure requirements in relation to LAC and deductions for holding non-capital LAC liabilities.

Capital that counts towards meeting the regulatory capital requirement (i.e., hard requirements, ignoring the 'softer' capital buffers) will generally count towards meeting a LAC requirement. This means that the new additional burden for a 'within-scope' Hong Kong-incorporated authorised institution will likely be the resolution component ratio.

iv Sanctions and anti-corruption

Hong Kong banks must comply with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Chapter 615 of the Laws of Hong Kong), which in particular sets out specific customer due diligence and record-keeping requirements that must be followed. In March 2015, the HKMA issued the guidance paper 'Anti-Money Laundering Controls over Tax Evasion'. The guidance paper is in addition to the HKMA's 'Guideline on Anti-Money Laundering and Counter-Terrorist Financing (for Authorized Institutions)', which was modified in March 2018 to reflect enhancements made in the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) (Amendment) Ordinance 2018 and subsequently updated in October 2018. Both the guidance paper and the Guideline assist authorised institutions in complying with the Anti-Money Laundering and Counter-Terrorist Financing Ordinance.

In September 2020, the HKMA announced the implementation of the Anti-Money Laundering and Counter-Financing of Terrorism Surveillance Capability Enhancement Project, which involves greater use of data and technology in the HKMA's supervision of money laundering and terrorist financing. In 2020, the HKMA also issued various publications to assist AIs with the operation of anti-money laundering and counter-terrorist financing systems, customer due diligence processes and remote customer on-boarding initiatives during the covid-19 pandemic.

Hong Kong-authorised institutions are required to check and report against the list of names issued under the US President's Executive Order 13224 and the list of names published under Hong Kong's United Nations (Anti-Terrorism Measures) Ordinance (Chapter 575 of the Laws of Hong Kong) (which is updated to reflect changes to the list of specified terrorists and terrorist associations designated by the United Nations Security Council).

Hong Kong has a separate enforcement agency, the Independent Commission Against Corruption, to counter corruption. Its main focus is on preventing bribery (in both the public and private sectors).

v Benchmarks

The Hong Kong Interbank Offered Rate (HIBOR) is available for borrowings in Hong Kong dollars and yuan (although the majority of offshore yuan-denominated loans do not use the HIBOR in respect of interest calculations). The HKMA issued a statutory guideline 'Code of Conduct for Benchmark Submitters', which came into effect on 3 May 2013 and was revised on 23 August 2013. The guideline forms part of the HKMA's Supervisory Policy Manual.

Following the recommendation of the Financial Stability Board (FSB), the Treasury Market Association (TMA) has proposed to adopt the Hong Kong Dollar Overnight Index Average (HONIA) as an alternative reference rate (ARR) to HIBOR. Notwithstanding this, the TMA see it desirable and necessary for HIBOR to remain (unlike the UK Financial Conduct Authority's approach to the London Interbank Offered Rate (LIBOR)). There are no plans to discontinue HIBOR.

The HKMA is monitoring closely authorised institutions' progress to replace LIBOR given the common usage of LIBOR in the Hong Kong loans market (particular for US$ loans). As most recently described in its circular issued on 25 March 2021, the HKMA expects authorised institutions to endeavour (and put in place detailed work plans) to be in a position to achieve the following LIBOR transition milestones: (1) authorised institutions should be in a position to offer products referencing the alternative reference rates (ARRs) to LIBOR from 1 January 2021; (2) adequate fall-back provisions should be included in all newly issued LIBOR-linked contracts that will mature after 2021 from 1 January 2021; and (3) authorised institutions should cease to issue new LIBOR-linked products by 31 December 2021.

vi Banking resolution

EU Bank Recovery and Resolution Directive

With the implementation of Article 55 of the EU Bank Recovery and Resolution Directive (2014/59/EU), EU-based lenders typically require loan facilities that are governed by Hong Kong law to include contractual recognition of bail-in – whereby non-EU entities acknowledge that EU lenders may be subject to bail-in powers under that EU directive. The relevant language is usually based on the bail-in template language prepared by the Loan Market Association.

Hong Kong Financial Institutions (Resolution) Ordinance

Hong Kong's Financial Institutions (Resolution) Ordinance came into force on 7 July 2017 and is designed to meet international standards set by the FSB. In due course, contractual recognition of bail-in for non-Hong Kong law contracts will be required. On 31 December 2020, the HKMA issued consultation conclusions on the 'Rules on Contractual

Stays on Termination Rights in Financial Contracts for Authorized Institutions', which takes a limited and practical approach. There will be no requirement to amend existing contracts (other than existing contracts that are subsequently subject to material amendment).

On 7 July 2017, the HKMA issued three Codes of Practice: 'Resolution Planning – Core Information Requirements', 'Operational Independence of the Monetary Authority as Resolution Authority' and 'The HKMA's Approach to Resolution Planning'.

The Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules (Chapter 628B) (LAC Rules) set out detailed LAC rules for authorised institutions. The LAC Rules are designed to be aligned with the international standards on LAC set by the FSB in its 'Total Loss-absorbing Capacity Term Sheet'. On 20 March 2019, the HKMA issued a new related Code of Practice: 'Resolution Planning – LAC Requirements' and on 31 October 2019, it published a set of standard disclosure templates (with accompanying explanatory notes) with respect to loss-absorbing capacity under the LAC Rules.

The Draft Code of Practice chapter OCIR-1 'Resolution Planning – Operational Continuity in Resolution' was open for industry consultation until 1 April 2021.

vii Insolvency regime

Hong Kong's insolvency regime remains creditor-friendly with no specific debtor resolution regime in place.

On 22 October 2020 the Hong Kong government issued a paper to the Legislative Council stating that it intends to introduce a corporate rescue regime sometime in 2021. The proposals include:

a the introduction of an insolvent trading prohibition, under which a director responsible for insolvent trading of a company will be liable to make a contribution to the company's assets as the court considers appropriate. The director's liability is civil in nature. The regime will introduce a lower threshold for liability compared to the existing fraudulent trading regime; and

b the introduction of a corporate rescue procedure with a statutory moratorium. The statutory moratorium is expected to prohibit enforcement, including self-help enforcement of security. Lenders may well change their approach to security documents as the statutory moratorium cannot be put in place if a holder of a charge over all or substantially all of the company's assets objects to the statutory moratorium. Secured lenders may therefore consider amending their policies on taking security in order for the secured lenders to have the right to prevent the imposition of a statutory moratorium.

III TAX CONSIDERATIONS

The Hong Kong tax regime includes three separate types of income tax – property tax, salaries tax and profits tax. Of these, profits tax is most relevant to lenders.

Hong Kong does not have a separate capital gains tax regime.

i Profits tax

Hong Kong adopts a territorial source principle of taxation.

Under the Inland Revenue Ordinance (IRO) (Chapter 112 of the Laws of Hong Kong), profits tax is charged on a person carrying on a trade, profession or business in Hong Kong; and in respect of income profits (excluding capital gains profits) arising in or derived from Hong Kong from that trade, profession or business.

The rate of profits tax for corporations is 8.25 per cent on profits up to HK$2 million and 16.5 per cent on the remainder for the year of assessment commencing 1 April 2021 (unchanged from the rates for the year of assessment commencing 1 April 2019). In the 2021–2022 Budget, the Financial Secretary proposed a one-off reduction of profits tax for the year of assessment 2020/21 by 100 per cent, subject to a ceiling of HK$10,000 per case. This measure will be effected by an amendment to the IRO.

Carrying on a trade, profession or business in Hong Kong

A low threshold is required to fall within the scope of carrying on a trade, profession or business in Hong Kong. The activity of depositing may, for example, be sufficient to constitute a business.

Income arising in or derived from Hong Kong

If the above test – of carrying on a trade, profession or business in Hong Kong – is satisfied, profits tax will (subject to exemptions) be chargeable if the income arises in or is derived from Hong Kong.

This is a factual issue, which is determined by looking at what the taxpayer has done to earn the relevant profit. A test often applied in difficult cases is where the operations take place from which the profits in substance arise. The place where a taxpayer's profits arise is not necessarily the place where he or she carries on business.

Inland Revenue Department guidelines and case law assist in determining the locality where income arises, or where it is derived from.

Because of the difficulties in assessing the locality of interest and related fee income received by financial institutions, the Inland Revenue Department issued Departmental Interpretation and Practice Notes No. 21: Locality of Profits (revised July 2012), setting out the Inland Revenue Department's current practice.

A modified extract from the practice note on the tax treatment of interest from loans is set out below.

Types of interest incomes from loans	Tax treatment
Offshore loans initiated, negotiated, approved and documented by an associated party outside Hong Kong and funded outside Hong Kong (i.e., funds raised and loaned direct to the borrower by a non-resident; for example, head office, branch, or subsidiary) albeit through or in the name of the Hong Kong institution.	100 per cent non-taxable
Offshore loans initiated, etc., by the Hong Kong institution and funded by it in or from Hong Kong.	100 per cent taxable
Offshore loans initiated, etc., by an associated party outside Hong Kong but funded by the Hong Kong institution.	50 per cent taxable
Offshore loans initiated, etc., by a Hong Kong institution but funded by offshore associates. It is considered that this category only applies to start-up positions where the Hong Kong institution has yet to establish a market presence.	50 per cent taxable

Note on 'funding'.
For claims concerning loans funded by offshore associates, two essential requirements will have to be satisfied, namely:

a that the Hong Kong institution does not have the authority to seek its own source of funds in respect of the loans; and

b there must be documentary evidence to show that funds have been directly provided by an offshore associate even though such funds may have been routed through another vehicle in Hong Kong. In other words, arbitrary funding by another group vehicle in Hong Kong will not satisfy this requirement.

Note on 'initiation'.
'Initiation' refers to the efforts exerted in obtaining the particular business including solicitation, negotiation and structuring of the loans. The financial institution must be able to substantiate that the mandate or invitation to participate was secured as a direct result of the activities of an associated party outside Hong Kong for an offshore claim to succeed.

Participation, commitment and other fees will follow the tax treatment accorded to the related loan under the above.

Deductibility of interest paid by borrowers

Payments of interest by a Hong Kong corporate that are incurred in the production of its chargeable profits are generally deductible, subject to certain anti-avoidance provisions that limit the available deduction where money is not borrowed from a financial institution or from a person who is taxable in Hong Kong on the interest received. The anti-avoidance provisions seek to deal with the lack of symmetry in tax treatment on interest received and interest paid.

ii Double taxation agreements

As at 4 January 2021, Hong Kong had comprehensive double taxation agreements with Austria, Belarus, Belgium, Brunei, Cambodia, Canada, the Czech Republic, Estonia, Finland, France, Guernsey, Hungary, India, Indonesia, Ireland, Italy, Japan, Jersey, Korea, Kuwait, Latvia, Liechtenstein, Luxembourg, Macao SAR, mainland China, Malaysia, Malta, Mexico, the Netherlands, New Zealand, Pakistan, Portugal, Qatar, Romania, Russia, Saudi Arabia, South Africa, Spain, Switzerland, Thailand, the United Arab Emirates, the United Kingdom and Vietnam.

The terms set out in double taxation agreements take precedence over the other provisions of the IRO.

iii Stamp duty

Hong Kong stamp duty is chargeable on certain transactions (including the issue of certain bearer instruments) but is not chargeable on the entering into or transfer of loan facility agreements (on the basis that a transfer under a loan facility typically will not require registration in a register located in Hong Kong).

Lenders may, therefore, transfer their commitments and loans by way of either assignment or novation.

IV CREDIT SUPPORT AND SUBORDINATION

i Security

Common methods of taking security in Hong Kong include the following:

a mortgages:
- which involve the mortgagor transferring the property to the mortgagee, with the mortgagor having an equitable right to have the property returned upon paying off the debts to which the mortgage relates. Although it may be used for a variety of types of properties, it is more commonly used for real property. The Conveyancing and Property Ordinance (Chapter 219 of the Laws of Hong Kong) sets up a statutory overlay in respect of Hong Kong real property, so that any mortgage of a legal estate in Hong Kong real property may only be effected at law by a deed expressed to be a legal charge (which is a creature of statute);

b charges or assignments by way of security:
- Hong Kong recognises both fixed and floating charges, with fixed charges taking priority over floating charges where the chargee has had no notice of negative pledge prohibitions. Charges may be granted over future property; and
- security over choses in action are usually drafted as an assignment by way of security – although the courts make little distinction between (1) charges and (2) assignments by way of security;

c pledges (by way of transfer of possession of tangible property); and

d liens (by way of the lienholder retaining possession of tangible property).

The typical ways of taking security over real estate; tangible movable property; shares and financial instruments; contractual rights and receivables; and intellectual property (IP) rights are described below.

Real estate

Security over Hong Kong real estate is typically given by way of a fixed legal charge (whereas security over choses in action related to the property is given by way of an assignment). Although lenders are not required to adopt any specific mortgage form, The Hong Kong Mortgage Corporation Limited has introduced a set of standard form model mortgage documents in respect of residential properties.

Security granted over a registrable interest in land must be registered with the Land Registry.

Tangible movable property

Security over tangible movable property is often given by way of a fixed or floating charge.

Fixed charge is created over a particular identified property (which may include future property). The chargee's consent is required for the chargor to dispose of the property free from the charge. If the chargor defaults, the chargee may enforce the charge by selling the property. Typically, the chargee will appoint a third-party receiver to enforce the charge to protect the chargee from potential liability arising from enforcement.

Floating charge is similar to a fixed charge but created over a moving class of assets (such as stock), which may change on occasion. Unlike a fixed charge, the chargor may dispose of the charged assets and carry on its business as usual until an event (such as acceleration under

an event of default) occurs that crystallises the floating charge into a fixed charge. Floating charges rank behind fixed charges granted (before floating charge crystallisation) over the same property and behind certain preferential creditors prescribed by statute.

To reduce the risk of tangible charged property being sold to a bona fide purchaser of the legal estate without notice of the charge, where possible, plaques should be attached to the charged property to give notice to third parties of the existence of the charge.

Shares and financial instruments

Security over shares and financial instruments is often given by way of a fixed or floating charge.

The charging language used will depend upon whether the shares are held directly in certificated form or indirectly via a nominee or custodian.

In the case of a charge over Hong Kong shares held directly in certificated form, the chargor will transfer the share certificate to the chargee and execute a blank form of instrument of transfer and a blank sale contract note, which the chargee may complete upon enforcement and use to transfer the shares to a third party. The chargee may also ask the chargor to arrange for the signature – by the directors of the underlying company whose shares are charged – of certain undated board resolutions and undated resignation letters of directors, with authority for the chargee to complete these documents upon enforcement.

Unless the share charge extends to a charge over dividends, notice is typically not sent to the company whose shares are charged as this will not affect priorities (Section 634 of the Companies Ordinance states that no notice of trust may be entered in a Hong Kong company's register of members). This means that, under a share charge, a chargee is exposed to the risk of a chargor transferring legal title to the charged shares to a bona fide purchaser without notice. Such a bona fide purchaser without notice would likely take the shares free of the charge. Although the chargee holds the share certificate, the chargor may apply to the company for a new share certificate on the basis that the previous share certificate has been lost or destroyed. Although there is a court process under which a 'stop notice' may be served by the chargee on the underlying company whose shares are charged, requiring the underlying company to give notice to the chargee if the chargor attempts to transfer the shares, this process is rarely used.

When taking security over shares and financial instruments, the terms governing the underlying shares or instrument must be checked to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

In the case of a charge over shares held indirectly via a nominee or custodian, the charging language is more similar to that used for contractual rights and receivables (described below). Notice of the share charge should be sent to the nominee or custodian to preserve priority.

For other financial instruments, notice of a charge should usually be given to preserve priority (with the notice given to the person who either owns the instrument on behalf of the chargor, or to the payor under the instrument, as applicable).

Contractual rights and receivables

Security over contractual rights and receivables is usually drafted in the form of an assignment by way of security. Courts make little distinction between a fixed charge and an assignment by way of security.

As for shares and other instruments, the terms of the contractual rights and receivables should be reviewed to ensure there are no provisions prohibiting transfer (and, if there are, those provisions should be amended).

Notice of charge should be given to the debtor or payor to which the contractual rights and receivables relate to preserve priority.

IP rights

Hong Kong has specific registries for patents, trademarks and designs, although there is no registry for copyright.

Security is usually taken in the form of a mortgage, charge or assignment, by way of security.

Security over registered IP should be registered at the Hong Kong Patents Registry, the Trade Marks Registry or the Designs Registry. If the security is not registered, it is ineffective against certain acquirers who acquire the IP without notice of the security. There is no legal requirement to make the registrations within a specified time, although late registration may impact upon damages claims as well as priority and perfection against third parties.

Formalities

Hong Kong real estate – the Land Registry

Security over Hong Kong real estate (if registrable) must be registered with the Land Registry to protect its priority. If the document is registered within one month of execution, it takes priority from the date of execution. Late registrations will take priority from the date of registration.

The Companies Registry

Where the grantor is a Hong Kong-incorporated company; or a non-Hong Kong company that is registered at the Companies Registry (usually required by reason of having a place of business in Hong Kong) that is granting security over Hong Kong property, specified types of securities must be registered with the Companies Registry within one month of execution. Otherwise, the security will be void against any creditor or liquidator, and the chargor company (and certain of its officers) will commit an offence.

The following are the more common types of securities that must be registered, including over:

a any property where the security granted is a floating charge;
b chattels;
c land;
d book debts (but excluding bank accounts);
e ships;
f aircraft; and
g goodwill, patents, trademarks and copyright.

The full list of securities that must be registered is set out in Section 334 of the Companies Ordinance.

Although security over a bank account is not registrable as a book debt, it will be registrable if the security is a floating charge. The question of characterisation of security is a matter of both form and substance. A factor to take into account will be the nature of the dealings and interactions between the chargor and chargee.

Registration requirements also apply where an asset is acquired that is subject to security.

IP registers

Security over patents, registered designs and trademarks are subject to specific registrations:

a security over patents and registered designs must be recorded at the Hong Kong Patents Registry by filing Form P19 or at the Designs Registry by filing Form D5; and

b security over a registered trademark must be registered at the Trade Marks Registry by filing Form T10.

An unregistered security interest over a registered patent, design or trademark is ineffective against certain acquirers who did not have notice of the security interest at the time of the acquisition.

Aircraft

Although there is no statutory duty, market practice is to notify the Civil Aviation Department in Hong Kong of the security interest, and to include chargee details on the nameplate of the aircraft to give notice of the security interest to third parties.

Ships

Security over ships is usually by way of mortgage. A mortgage over a Hong Kong-registered ship must be in a prescribed form and registered with the Hong Kong Shipping Registry. Priority is accorded from the time of registration.

ii Guarantees and other forms of credit support

Guarantees are commonly used in Hong Kong as a form of credit enhancement. Market documentation prepared by the Asia Pacific Loan Market Association includes loan facility agreements with integrated guarantee provisions.

Other credit support techniques that may be used include sale and leasebacks, transfer of collateral with an obligation to return the same (or equivalent) collateral, disposal of receivables with recourse remaining against the transferor, retention of title arrangements and contractual set-off arrangements.

Negative pledge undertakings are usually included in loan facility agreements. Breach by a borrower of a negative pledge entitles the lender to bring a damages claim as an unsecured creditor, but breach is unlikely to disturb the security granted in favour of a bona fide third party created in breach of the negative pledge.

iii Priorities and subordination

Subordination of debts

A lender may commonly seek subordination of debt owed by the borrower to creditor shareholders, so that the lender's loan ranks in priority to the creditor shareholders' loans. Such subordination is effected by way of contract, often by way of a deed of subordination between the borrower, the lender and the creditor shareholders.

Structural subordination is also permissible.

Priority of competing security interests

Priority is a complex matter that depends upon the particular facts and the relevant registrations (if any).

A common priority concern arises where a company grants security by way of two fixed charges over the same debt chose in action to two creditors. The starting point under common law is that the creditor who gives notice first to the debtor takes priority over the other creditor. If that fixed charge is registrable at the Companies Registry, to preserve priority the fixed charge must be registered within the required period of one month after execution. The Companies Ordinance requires that the instrument of charge must be registered in full. The text of the instrument of charge is therefore available to the public for a small fee.

Although it is unclear how registration under the Companies Ordinance legislation affects the doctrine of notice, it is expected that registration of an instrument of charge will likely give rise to constructive notice of all the terms in the charge instrument – including negative pledge clauses – on the part of those who may reasonably be expected to search the Companies Registry, including banks, financiers and relevant professionals. It would appear that, for example, where a company grants a charge over a debt chose in action to a 'first financial institution' and then subsequently grants a charge over the same debt chose in action to a 'second financial institution', the first financial institution may take priority if the second financial institution would have been aware of the first financial institution's interest had it searched the Companies Registry (regardless of whether the first financial institution has given notice to the debtor). In a similar way, negative pledges in floating charges may now bind later financial institutions that have a fixed charge interest in the same asset.

V LEGAL RESERVATIONS AND OPINIONS PRACTICE

Legal limitations on the validity or enforceability of lending and secured arrangements are described below.

If lenders (including via their agents) are put on notice that a borrower may not have properly convened and held the board meeting that authorised the relevant loan and security documents, the court may find that the documents do not bind the company. Care needs to be taken by lenders' counsel that there are no irregularities that would so put lenders on notice. A particular case (*Moulin Global Eyecare Holdings* [2010] 1 HKC 90) where the courts found a lender had notice of irregularities, involved the lender's counsel preparing draft board minutes and (as requested by the borrower) including in those minutes – prepared prior to the meeting – the list of specified directors of the borrower-listed company who were to attend the meeting. The specified directors were all connected to the controlling shareholder family, and none of the five non-executive directors (including three independent non-executive directors) were included in the list. In the circumstances, which included there being little time to give notice of the meeting to all directors, the court found that the loan and related security documents did not bind the borrower-listed company.

Previous legal opinions concerned with financial assistance, leading to loans and security being unenforceable, no longer apply for documentation entered into on or after 3 March 2014, when Hong Kong's consolidated Companies Ordinance legislation came into effect. Financial assistance remains an offence, and so remains a concern for subsidiary guarantors and subsidiary security providers.

The way in which a non-Hong Kong corporate may execute Hong Kong law-governed deeds (such as charges) is more restrictive than most common law jurisdictions. If execution is not by way of affixation of a common seal or under a power of attorney that is valid in the corporate's place of incorporation, a reservation may be made in a legal opinion. As of

3 March 2014, the procedure for a Hong Kong-incorporated company to execute a Hong Kong law-governed deed has been relaxed, but the relaxation does not apply to non-Hong Kong corporates.

Although there is no binding Hong Kong case law in this area, Hong Kong practice is to follow the *UK Mercury*[5] case for the steps to take when executing a deed. If signature pages are executed as a deed and the executed signature pages are later attached to the rest of a document expressed to be a deed and governed by Hong Kong law, a reservation may be made in a legal opinion.

Hong Kong law follows the doctrine of absolute Crown immunity (for the People's Republic of China but excluding Hong Kong), and the doctrine of absolute state immunity (for foreign states). Immunity cannot be waived by the parties by way of including a waiver in the underlying agreements. Immunity can, however, be waived in the context of a particular dispute that has already arisen; or in advance, in an international treaty between the foreign state and the forum state. Legal opinions may therefore include assumptions that the parties are not Crown or foreign state entities.

Registry filings are made after the event and so are not up to date. The best evidence for ascertaining directors and members of a company can be found in the statutory books kept by the company, although these are not typically reviewed unless a shareholder is granting a charge over its holding of shares in the company.

Where security is granted, the prohibitions set out in the underlying asset being charged will impact upon whether the security can be realised. Obvious concerns are as follows:

a a charge over shares in a company where company directors have discretion not to register a transfer of shares; and

b security over a contract where that contract does not permit parties to dispose of their interests.

Legal opinions usually set out the relevant registry filings that must be made upon the creation of security, and then assume those filings will be made within the prescribed time limits.

Legal opinions cover the valid creation of security, but do not go further to describe the type and ranking of security given the complexities of this area of law.

VI LOAN TRADING

Loan trading is usually carried out by way of novation and assignment, and both methods are catered for in Asia Pacific Loan Market Association primary documentation. Sub-participations and synthetic methods are available but less commonly used.

VII OTHER ISSUES

If a lender is not an authorised institution licensed by the HKMA, it may fall under the Money Lenders Ordinance (Chapter 163 of the Laws of Hong Kong) if it is carrying on a business in Hong Kong (whether itself or through agents) of making loans, or if it advertises or announces itself as carrying on that business. This legislation seeks to protect consumers against unfair credit transactions – for example, by requiring money lenders to be licensed

5 *R (on the application of Mercury Tax Group and another) v. Revenue and Customs Commissioners and others* [2008] EWHC 2721 (Admin).

– and for money lenders to use prescribed forms and not to charge compound interest. Breach of the Money Lenders Ordinance may result in the commitment of offences, and underlying transactions being unenforceable. A number of loans are exempted from the above requirements (including the requirement to be licensed to lend money). A commonly used exemption is for loans made to a company that has a paid-up share capital of not less than HK$1 million (or its equivalent in another currency).

A lender who is not an authorised institution licensed by the HKMA must abide by the usury laws set out in the Money Lenders Ordinance, which requires loans and securities not to be 'extortionate'. There is a statutory presumption that a transaction is extortionate where the effective rate of interest exceeds 48 per cent per annum.

VIII OUTLOOK AND CONCLUSIONS

The Hong Kong government is expected to submit legislative proposals to the Legislative Council in 2021 to introduce: (1) a corporate rescue regime; and (2) an insolvent trading prohibition (contravention of which may expose directors to civil liability to make contributions to the insolvent company). Further details are mentioned above in Section II.

There will be continuing focus on the promotion of green and sustainable banking.

The HKMA will continue to encourage the banking industry to implement regtech. In the past few months, the HKMA has, for example, highlighted use cases for technology in credit risk management, anti-money laundering processes and surveillance capability.

Appendix 1

ABOUT THE AUTHORS

PETER LAKE

Slaughter and May

Peter Lake is a partner in Slaughter and May's Hong Kong office. He is involved in a wide range of corporate, regulatory, banking and finance work, advising companies, financial institutions and fund management groups. He advises on acquisitions, investments and financings as well as providing regulatory advice to a number of funds and financial institutions. He is listed as a Global Leader in the 2021 edition of *Who's Who Legal Banking: Finance* and *Who's Who Legal Banking: Regulatory*, and as a leading lawyer in the *IFLR1000 Asia-Pacific 2021* for Banking in Hong Kong. He is recommended in *Chambers Asia-Pacific 2021* for Banking & Finance: Hong Kong-based (International Firms), China, and Financial Services: Non-contentious Regulatory (International Firms), China. He is a member of the APLMA Hong Kong Documentation Committee. Mr Lake read law at Emmanuel College, Cambridge, and is qualified in England and Wales and in Hong Kong.

SLAUGHTER AND MAY

47th Floor, Jardine House
One Connaught Place, Central
Hong Kong
Tel: +852 2521 0551
Fax: +852 2845 2125
peter.lake@slaughterandmay.com
www.slaughterandmay.com

an LBR business

ISBN 978-1-83862-800-0