DENIS CHANG'S CHAMBERS

COVID-19 – The Law Un-Masked: Risks and Remedies for Non-Recourse Stock Loan Agreements in a Pandemic Market

In our eighth article in the series "The Law Un-Masked", Earl Deng and Tara Liao examine legal issues arising in non-recourse stock loan agreements and the steps both investors and lenders may take to safeguard their rights.

Non-recourse stock loan agreements are a type of financing arrangements secured by shares of companies where the lender would look exclusively to the collateral as agreed for repayment in the event of a default.

When done right, non-recourse stock loan agreements provide a valuable option for individuals who wish to leverage and capitalize on their equity without selling up or relinquishing control of their companies. However, such agreements can be risky to both borrower and lender as the market is largely unregulated, unregistered and most likely involves offshore holdings. In particular, where the underlying collaterals are shares of listed companies, such loans may carry significant legal and financial risks, not least due to stock market volatility fueled by the coronavirus.

What are Non-Recourse Stock Loans?

The usual features of non-recourse stock loans ("**NRL**") are as follows:-

(1) The borrower pledges shares as collateral for the loan, and the lender's sole remedy in an event of default ("**EOD**") is to foreclose on the collateral;

(2) The upside is that the borrower can leverage the equity whilst retaining the benefits of "ownership" and any increase in the stock price whilst limiting the risk of loss to the money received from the loan;

(3) On completion of the loan, the lender must return the same number of equivalent shares to the borrower upon repayment of the principal and interest of the loan;

(4) The lender would usually insert a hypothecation clause, entitling the lender to deal with the shares, hedge its risks and protect its own portfolio for the duration of the NRL;

(4) Another prominent feature which makes the NRL susceptible to market volatility is that if the market closing price of the shares drops below a certain level, EOD will be triggered which entitles the lender to forfeit the shares;

(5) The lender will usually require the shares to be held in a licensed securities firm in an account opened by the borrower, with the securities firm acting as the custodian agent of the lender; and

(6) If an EOD is triggered, the lender will look to the shares only.

The Risks of Non-Recourse Stock Loans

While conceptually simple, it is important to understand the risks and concerns of NRL:

(1) **The lender may fail to perform its obligations**. It is important before entering into any non-recourse stock loan to conduct due diligence on the lender especially on: (i) whether it is a licensed lender under the Money Lenders Ordinance, Cap. 163 ("**MLO**"), or a licensed person under the Securities and Futures Ordinance (Cap. 571); (ii) whether they are registered and/or has substantive assets/business in Hong Kong and are financially stable; (iii) whether it is the entity advancing the loan or it is relying on a third party (or a chain of third parties) to advance the capital to the borrower; (iv) the investment plan for safeguarding its position in relation to the pledged shares.

(2) **The lender may sell the shares.** The delineation between "hypothecation" for a purpose of "portfolio protection" and outright sale is grey as a matter of law. This is because a lender may suggest that the sale was necessary due to the nature of the shares in question (company performance, volatility in market, etc.) which raises disputable issues of fact.

(3) **The loan may be void by virtue of contravention of section 23 of the MLO.** While there is no settled case-law on this issue, there is an interlocutory judgment in which the Court of First Instance accepted that there is a strong *prima facie* case that such loans may be found void (depending on the facts of the case) under section 23 of the MLO (see *Tsang Yan Kwong v 360 HK Limited & Another* [2018]CFI 1886).

(4) **Carve out "bad actor" clauses.** The lender may insert carve-out clauses which attract personal liability of the borrower over and above the collateral, such as fraud and material misrepresentation by the borrower. Such carve-outs are commercially sensible from the lenders' perspective. However, borrowers must watch out for the scope of the carve-outs, and for example, ensure that carve-outs are triggered by specifically defined events and the quantum of personal liability is subject to a cap or restricted to actual loss of the lender.

(5) **The EOD provision**. To mitigate the risk of stock-price-linked EOD due to market volatility, the EOD provision must be crafted and negotiated with care. For example, the EOD should be triggered by reference to average closing prices over a period of time and not the daily closing share price, and there should be mechanisms to cure the EOD within a given period of time.

(6) **Stock price may be inflated/manipulated before advancement of loan**. Because the amount of the loan advanced is generally linked to the market valuation of the shares immediately before the advancement of the loan, if the stock price is manipulated and inflated beforehand, the lender may not be able to recover the loan amount from the proceeds of the sale of the collateral. Lenders should therefore observe and evaluate the stock in question carefully before advancing the loan.

Remedies in Event of an EOD

From the lender's perspective, the most effective remedy in the event of an EOD is to realise the value of the collateral, usually by way of a sale or hypothecation. It may also consider going after the borrower personally if deemed viable under the "bad actor" clauses mentioned above.

From the borrower's perspective, in a fast moving market, it is of paramount importance to act swiftly in order to track down the shares and prevent further transfer or dissipation of the shares or their proceeds. (See for example *Silver Universe Investment Ltd v China Times Securities Ltd & Others*, HCA 1824/2018 18, January 2019 and 29 March 2019, discussed in one of our case commentaries.)

When the lender asserts an EOD, the borrower is entitled to challenge that assertion and/or seek equitable relief for the return of the shares:-

(1) The borrower may consider applying for a Mareva injunction to freeze the lender's assets. This may be available even if the borrower does not have a proprietary claim.

(2) The borrower may consider applying for a proprietary injunction to preserve the shares and/or their traceable proceeds. For this, a serious issue to be tried in respect of the proprietary claim will need to be shown. A proprietary injunction may be available even where there is delay on the part of the borrower (which is often fatal to a Mareva injunction);

(3) The borrower should also consider applying for a Norwich Pharmacal order to seek discovery from securities firms which may have been involved in the transfers of the shares and the disposal of the proceeds of the shares.

Tracing of Shares/Proceeds: Characterisation of Lender's Interest in the Shares

Ultimately, the borrower's ability to recover the shares/proceeds depends on the characterisation of the respective interests of the borrower and the lender – does the loan agreement create a mere security interest to the lender, or does it assign the shares to the lender outright? The characterisation of the interest is important in that:

(1) If the lender has a security interest only, the borrower as mortgagor retains the right in equity to redeem the shares even after EOD, and the Court has consistently held that any contractual provisions purporting to clog or fetter the equity of redemption are void; and

(2) The borrower further has the right to hold the lender liable as mortgagee to account for proceeds from the sale of the shares.

The approach to this issue was discussed in *Ding Huirong v China Times Securities Investments Limited & Another* [2020]CFI 376, as well as the Singapore case of *CPIT Investments Ltd v Qilin World Capital Ltd* [2017] SGHC(I) 05. While each case turns on its facts, it appears that a few general themes can be discerned:

(1) The Court will consider the transaction as a whole, by reference to all the provisions, including those purporting to negate or are inconsistent with the existence of an equity of redemption, to ascertain whether the parties' intention is to create a security interest. An individual provision supportive of/against a security interest alone is not determinative and merely a factor to be taken into account.

(2) An important question is whether the lender has an unfettered right to deal in the shares, or whether such is subject to limitations and must be exercised for specified purposes, such as hedging risks or for the protection against the loss of principal and interest. Restrictions of the right to deal in shares tend to show that the lender's interest is a security interest.

(3) It is often contended by lenders that the requirement for the lender to return the same number of equivalent shares but not identical shares shows that the borrower does not retain any proprietary interest in the shares. However, in both cases, the Courts have held that this factor does not in itself change the nature of what is otherwise a security interest.

It is important to know that "Non" recourse does not mean "No" recourse. Redemption may yet be possible for those who act quickly in this roller-coaster market.

This article was produced by Earl Deng and Tara Liao.

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