Asia Pacific Guide to Lending and Taking Security - Hong Kong SAR

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# When considering whether to lend

## 1. Is it necessary or advisable for any lender, arranger, facility agent or security agent to be licensed, qualified or otherwise entitled to carry on business in this jurisdiction: (a) by reason only of its execution, delivery or performance of the finance documents; or (b) to enable it to enforce its rights under the finance documents?

A lender, arranger, facility agent or security agent ("**Finance Party"**) that is a party to any loan or security arrangements with a company located in Hong Kong is generally not subject to any licensing requirements provided it is an “authorized institution” (AI) under the Banking Ordinance (BO). There are three types of AI, namely, licensed banks, restricted license banks and deposit-taking companies.

If a Finance Party is not an AI, but intends to lend money in Hong Kong (e.g., whether to a Hong Kong company or other legal person, or if the loan is advanced in Hong Kong), then the Money Lenders Ordinance (MLO) imposes licensing and other compliance requirements that may apply to a non-AI lender. The MLO requires any lender (other than an AI) that is in the business of making loans in Hong Kong (or who advertises, announces or holds themselves out as doing so) to obtain a money lenders’ license and to comply with various requirements relating to the making of loans.

Exemptions from the MLO licensing requirements and most of the MLO compliance requirements (other than in relation to restrictions on charging excessive interest rates) are available, namely, in respect of “exempted persons” and “exempted loans” (as specified in Schedule 1 of the MLO).

Exempted persons include banks incorporated or established outside Hong Kong that are considered by the Hong Kong Monetary Authority (HKMA) (pursuant to a declaration to be obtained from the HKMA on a case-by-case basis) to be subject to prudential supervision by a recognized banking supervisory authority.

Exempted loans include, amongst other, loans made to any of the following persons:

A company where the loan is secured by a mortgage, charge, lien or other encumbrance that is registered under the Companies Ordinance (CO).

A company that has a paid-up share capital of not less than HKD 1,000,000 (or an equivalent amount in any other approved currency which is freely convertible into Hong Kong dollars).

A company the shares or debentures of which are listed on a recognized stock market (or any subsidiary of that company).

Securities margin financing-related activities may be regulated separately by, or require compliance with, Guidelines, Codes or Rules published or overseen by the Securities and Futures Commission (SFC). This may include (except in the case of an AI lender for which an exemption may be available) a requirement for licensing by the SFC.

## 2. Will any lender, arranger, facility agent or security agent be deemed to be resident, domiciled, carrying on business or subject to tax by reason only of the execution, delivery, performance or enforcement of the finance documents?

**Carrying on business**
The execution, delivery and enforcement of loan or security documents in Hong Kong do not, of themselves, usually lead to the conclusion that a Finance Party is carrying on business in Hong Kong, nor would those acts generally result in a Finance Party being deemed to be resident or domiciled in Hong Kong. However, the performance by a Finance Party of its obligations under a loan or security document in Hong Kong might suggest that the relevant person is carrying on business in Hong Kong. For example, where the facility agent function is carried out through an office or branch in Hong Kong or the loan is arranged through employees operating in Hong Kong.

**Residence**
Residence is usually determined in the first instance by the place of incorporation. However, a company may be resident in a particular place, even though it is not incorporated there, if its central management and control is exercised there. As the tax system in Hong Kong does not adopt a residence basis of taxation, residence is generally not relevant in the context of determining a company’s tax liability in Hong Kong.

**Domicile**
Domicile is not relevant for tax purposes in Hong Kong.

**Tax**
Hong Kong profits tax is territorial in nature and only profits which have, or which are deemed to have, a Hong Kong source are subject to profits tax. To be liable to profits tax:

A person must carry on a trade, profession or business in Hong Kong

The person must derive profits from that trade, profession or business, other than profits arising from the sale of capital assets

Those profits must arise in, or be derived from, Hong Kong

Whether interest or fees arise from the carrying on of a business in Hong Kong will be a question of fact to be determined based on all the circumstances in each case. If operations of substance relating to a transaction are carried out in Hong Kong, the relevant person would be regarded as carrying on business in Hong Kong.

The Hong Kong Inland Revenue Department and the Hong Kong courts have tended to the view that the threshold test for whether a person is carrying on business in Hong Kong is low. Ultimately, whether this is the case is a question of fact, and it is necessary to take into consideration all the activities of the Finance Party.

If in doubt, it is possible to obtain an advance ruling from the Hong Kong Inland Revenue Department (IRD) in relation to a specific arrangement or transaction. The ruling granted is only binding on the taxpayer applicant in relation to that particular transaction for the specified period provided the facts set out in the ruling are complete and remain correct. The IRD has a standard timeframe of up to six weeks (as noted in the Departmental Interpretation and Practice Notes No. 31 Advance Rulings as revised in April 2020) for processing any advance ruling application provided that all relevant information has been furnished. This timeframe can be extended for another six weeks if additional information is required. However, in more complex cases, a longer review period may be required by the IRD. The advance ruling mechanism is not available for stamp duty issues.

## 3. Are there any regulatory reporting requirements that lenders must observe in connection with those transactions?

To comply with the BO, if an institution is an AI (see the answer to question 1 of this section), it is generally required to submit periodic reports to the HKMA, including periodic reporting in relation to its assets, provisions and capital adequacy.

In addition, if a Finance Party carries on business in Hong Kong (see the answer to question 2 of this section), it must generally file annual profits tax returns that disclose specified information about the business. The financial accounts and a number of supporting documents must accompany the returns. The IRD can request any person to provide further information relevant for administering tax law. The IRD regularly uses this power to request further information and documents from taxpayers to assist it with its tax assessment.

## 4. Is it necessary to establish a place of business in your jurisdiction in order to enforce any provision of the finance documents?

No. Please also refer to the answer to question 1 of this section in respect of the applicable licensing requirements.

## 5. Is a foreign bank/financial institution permitted to approach local entities for business?

A foreign bank or financial institution that is an AI or a licensed money lender or that can avail itself of an exemption from the MLO may approach local entities for lending business. Please also refer to the answer to question 1 of this section in respect of the applicable licensing requirements, which also apply to foreign banks and financial institutions. In addition, approaching local entities for business may support the view that a foreign bank or financial institution carries on business in Hong Kong (please refer to our discussion in the answer to question 2 of this section).

In the case of a Hong Kong-incorporated AI, various lending restrictions may apply. For example, the BO provides for connected party lending limits (e.g., advances to directors and their relatives, certain controllers of the AI and employees who handle credit approvals for an AI and those employees' relatives), as well as large exposure limits (i.e., limits on the financial exposure of an AI to any single counterparty or any group of related counterparties).

Foreign banks and financial institutions that establish, with HKMA approval, a local representative office in Hong Kong are generally subject to strict restrictions in relation to the activities that their local representative office may conduct. These restrictions are generally imposed by way of conditions that the HKMA includes in its approval letter. Representative offices are generally prohibited from carrying out anything other than limited marketing, liaison or representational activities.

# When lending to borrowers

## 1. Are there any restrictions in relation to the type of borrower who may borrow foreign currency or in relation to the term of foreign currency and/or the amount of foreign currency borrowed by local entities?

No.

## 2. Are there any restrictions on the rate of interest or default interest that may be charged?

The MLO regulates the charging of excessive rates of interest by any person (other than an AI), whether or not that person is a money lender and regardless of whether an exemption from the MLO applies. Under the MLO, an effective annual interest rate in excess of 48% is illegal. In addition, an effective annual interest rate that exceeds 36% but does not exceed 48% is presumed to be extortionate and a Hong Kong court may reopen the underlying transaction.

Under the MLO, an agreement that provides, directly or indirectly, for the payment of compound interest to a money lender is illegal. Similarly, an agreement that provides for the payment of interest to a money lender at a default rate is illegal, except for simple interest on the principal amount of the amount in default at the same rate at which interest is charged on the principal amount that is not in default.

Although the MLO does not (and, therefore, the restrictions referred to above do not) apply to an AI, the Code of Banking Practice (a nonstatutory code that the HKMA expects all AIs to comply with) recommends that AIs also observe the MLO interest rate and default interest restrictions in relation to their dealings with customers who are individuals. However, there are no particular statutory restrictions on excessive interest rates or default interest in relation to loans by AIs to customers that are not individuals (e.g., Hong Kong companies). In any case, a provision in a loan agreement requiring any person to make any extra or increased payment as a result of a breach or a default (for example, a default interest provision) would be unenforceable if a Hong Kong court considered it a penalty.

## 3. Are there any restrictions on particular lenders or classes of lender entering into credit transactions with borrowers?

No, subject to the comments in the answer to question 1 of the “When considering whether to lend” section in relation to the licensing requirements for lenders.

## 4. Are there any exchange controls that will apply to payments to be made in foreign currencies or to foreign lenders?

No.

## 5. Is there any requirement to deduct or withhold tax from any amounts to be paid or repaid to a lender (whether domestic or foreign)? If so, at what rate must tax be deducted and from what kinds of payment?

No.

## 6. Are there any “thin capitalization” or other rules that may limit the extent to which interest payments may be deducted for tax purposes?

Hong Kong does not have a thin capitalization regime.

Generally, interest expenditure is deductible for tax purposes where it is incurred in the production of assessable profits. However, because certain types of interest income are exempt from tax in Hong Kong, there are specific situations in which deduction on interest may be limited to remove asymmetry that can arise where interest is deductible to the payer but is not assessable in the hands of the recipient. Broadly, these restrictions are concerned with situations where:

The interest payment is secured or guaranteed by a deposit that is made by the borrower (or its associate) to certain persons and the interest income on the deposit is not taxable in Hong Kong

The interest arises from an arrangement under which the interest payable is paid, directly or through an interposed person, back to the borrower (or a person connected or associated with the borrower) that is not assessed (or is chargeable at a reduced tax rate under certain tax concessions) on the interest income paid back

Failure to comply with these tests does not necessarily disallow deduction of the interest expense in its entirety. The restriction on interest deduction is confined to the portion of the interest relating to the portion of the loan, debenture or debt instrument that failed the tests and in respect of the time in which the failure persisted.

## 7. Are there any registration, notarization, translation or reporting requirements in relation to the loan documents?

No, provided that the loan documents do not contain any provisions creating registrable security. (See also the answer to question 1 of the section "When considering whether to lend" in relation to reporting requirements, as well as question 12 of the section "If taking security" in relation to security documents).

## 8. Are there any stamp, documentary, registration, notarization or other taxes, duties or fees chargeable in relation to the loan documents? If yes, what are the amounts and when are they payable?

No, provided that they do not contain any provisions creating registrable security. (See the answer to question 12 of the “If taking security” section in relation to security documents).

## 9. Does the law recognize the subordination of the debt that a debtor owes to one creditor to that which the debtor owes to another creditor? If yes, how is this usually effected?

It is possible to provide contractually for the subordination of the debt a debtor owes to one creditor (the subordinated creditor) to that which the debtor owes to another creditor (the senior creditor). This is usually effected by the debtor and the senior and subordinated creditors entering into a subordination deed (or, alternatively, an intercreditor deed, which usually sets out more detailed priority and intercreditor arrangements between the senior and junior creditors).

Under a typical contractual subordination, the senior and subordinated creditors agree that the subordinated creditor will not exercise its rights in respect of the relevant debt until the senior creditor has been paid in full.

Case law has confirmed the validity of contractual subordination arrangements in which a creditor agrees to waive, postpone or subordinate its debt to the debts of other creditors both before and on insolvency. However, any arrangement that interferes with the rights of other creditors might be called into question on the liquidation of the company.

## 10. Are there any classes of unsecured and unsubordinated creditor whose claims against a debtor would rank equally with or above those of the debtor’s other unsecured and unsubordinated creditors (e.g., the claims of employees and tax authorities or the claims of creditors under particular kinds of instrument)? If yes, what classes of creditors are preferred?

Certain classes of unsecured creditors are preferred by statute. These include certain debts due to employees (e.g., wages and salaries up to a specified amount) and the government (e.g., taxes and duties). In the case of the liquidation or winding-up of a Hong Kong company, the expenses of the winding-up (including the liquidator's remuneration) have priority over all other debts (preferential or otherwise) and any charge on goods distrained may also take priority over the rights of unsecured creditors. In addition, statutory insolvency set-off (see the answer to question 1 of the section "If things go wrong") may effectively confer priority on an unsecured creditor.

A lender to a Hong Kong entity should also be aware of the Partnership Ordinance. According to the Partnership Ordinance, where a loan is made at an interest rate that varies with the borrower's profits or where repayment is made by way of a share of the borrower's profits, the lender may be subordinated to the borrower's other creditors and, in certain cases, this arrangement may result in the lender being held to be a partner of the borrower unless it is clear from a consideration of all the relevant facts and the finance documents that the lender is not intended to be considered to be a partner of the borrower.

## 11. Are there any consumer protection or similar laws that apply if credit is made available to individuals or other classes of debtor? If yes, what laws are applicable?

Apart from the BO, the MLO and the Code of Banking Practice (a nonstatutory code that the HKMA expects all AIs to comply with) provide general principles and guidelines that an AI should observe in dealings with individual customers, including in making available loans or other facilities and in taking the benefit of guarantees or security. Where a licensed money lender is a member of the Licensed Money Lenders Association (LMLA), the nonstatutory LMLA Code of Practice provides similar guidance.

In addition, various general consumer protection ordinances may provide additional protections in the context of a lending relationship with a bank or financial institution (and, in particular, where the counterparty is a consumer and where it is dealing with the bank or financial institution in the ordinary course of business), such as the following:

The Control of Exemption Clauses Ordinance limits the effect and extent of exemption and the limitation of liability clauses if they are not considered reasonable.

The Unconscionable Contracts Ordinance provides that certain contractual terms are not enforceable if they have an unconscionable effect.

The Supply of Services (Implied Terms) Ordinance provides certain terms in the contractual relationship that suppliers of services, including lenders, must observe (e.g., an implied term to use reasonable care and skill).

The Trade Descriptions Ordinance outlines that it is an offense to use false trade descriptions or to provide false, misleading or incomplete information (this ordinance does not apply to AIs).

The Personal Data (Privacy) Ordinance provides statutory privacy protections for individuals.

## 12. Are there any prohibitions or limitations on the extent to which a company can give financial assistance for the purchase of: (a) its own shares or those of any affiliated company; or (b) assets owned by it or any affiliated company?

Under the CO, there are certain prohibitions on a company, private or public, incorporated in Hong Kong providing financial assistance in connection with the acquisition of shares in itself or its parent company.

The CO prohibits a company ("**Target**") from giving financial assistance directly or indirectly for the purpose of acquiring shares in itself or its holding company or for the purpose of reducing or discharging liabilities so incurred. Financial assistance includes assistance given by way of guarantee, security, indemnity, loan, novation or other similar agreement, gift or any other assistance by which the company's net assets are reduced to a material extent.

This only applies to financial assistance given by the Target or by any of its subsidiaries. Therefore, the prohibition does not apply where the assistance is given by a parent in respect of an acquisition of its subsidiary's shares or by a subsidiary to assist in the acquisition of its sister subsidiary's shares. Moreover, the prohibition applies only to financial assistance given by a Hong Kong subsidiary for the acquisition of its own shares or shares in its Hong Kong holding company. It does not restrict a Hong Kong subsidiary from giving financial assistance for the purpose of acquiring shares in its offshore-incorporated holding company.

The restrictions above apply to financial assistance given before or at the same time as the acquisition and to reduce or discharge a liability incurred for the purpose of (i.e., after) the acquisition.

There are some exceptions to the prohibition, including where the giving of financial assistance is authorized in accordance with the so-called whitewash procedure.

# If taking security

## 1. Are there any classes of unsecured and unsubordinated creditor whose claims against a debtor would rank equally with or above those of the debtor’s secured creditors?

Secured creditors generally stand outside the order of priority of payments because they are entitled to be paid from the proceeds of their security. The exception is a creditor secured by a floating charge (discussed in the answer to question 3 of this section). Creditors secured by a floating charge rank below preferential creditors (e.g., employees and the government).

## 2. May security given by a company rank in a specified order so as to secure liabilities owed to different creditors of the company in that order and, if that is not possible, is it viable for parties to enter into a contractual arrangement for the purposes of moderating this order?

Yes, it is possible to contractually provide for a specified order of priority among different creditors. This is usually effected by the creditors and the debtor entering into a subordination agreement or an intercreditor deed.

## 3. Does this jurisdiction recognise the concept of floating security or similar equivalent (i.e., security over a changing pool of assets that the company giving the security is free to buy, sell and generally deal with)?

Yes. A floating charge allows the chargor to continue to deal with the charged assets in its ordinary course of business until the charge “crystallizes” into a fixed charge over the assets in existence at the point of crystallization, usually on a specified crystallization event.

## 4. If so, are there any practical reasons why floating security is difficult to take, maintain or enforce?

There are certain issues that a security holder needs to be aware of when taking a floating charge as security. On the insolvency of the chargor, the security granted by a floating charge ranks behind all fixed charges and behind the rights of certain preferential creditors (see the answer to question 1 of this section). On a winding-up of the chargor, a floating charge that was created within 12 months, or, in the case of a charge that was created in favor of a person connected to the chargor, within two years, of the commencement of the winding-up is invalid except to the extent of new consideration from the chargee, if any, unless it is shown that the chargor was solvent immediately after the creation of the floating charge.

However, contractual protections can be included in security documents to control and to mitigate against these types of risks, including the ability to automatically crystallize a floating charge into a fixed charge immediately on the occurrence of certain events (e.g., where insolvency proceedings against the chargor have commenced or where the lender considers that the assets subject to the floating charge may be in danger of being seized or otherwise be in jeopardy). On crystallization, a floating charge becomes a fixed charge and ranks as a fixed charge. This means that it would rank behind an earlier fixed charge but it would have priority over subsequent fixed charges and floating charges.

## 5. May security be granted to a trustee to be held on trust for the lenders from time to time, in such a way that a change of lenders does not require new security to be taken?

Yes.

## 6. If not, are there any techniques that can be used to achieve substantially the same effect (e.g., parallel debt structures)?

Not applicable.

## 7. If an agent holds security for the lenders rather than a trustee, is it necessary to take new security on a change of lenders? If no, why not? If yes, are there ways to structure the transaction to avoid such a requirement?

In Hong Kong secured lending transactions, the security agent usually acts as a trustee for the lenders, although the security agent may not necessarily be given the title of "trustee." If the security agent acts as an agent and not as a trustee, it would be necessary to consider the terms of the security agent's appointment and the agency provisions in the transaction documents to determine whether new security would be required on a change of lenders. Therefore, the simplest and most practical approach is for the security agent to always act as a trustee in relation to the security.

## 8. Under the laws of this jurisdiction, is there any class of asset over which it is difficult or impossible to grant effective and perfected security, or in relation to which any security granted will be of limited effect?

Security may be conferred over most assets that are likely to be of interest to lenders as security for a financing transaction. However, lenders should note the following:

Future assets (i.e., those not in existence at the time of entering into the security document) may only be made the subject of equitable security, such as a charge, and not legal security, such as a legal mortgage. In practice, the distinction is unlikely to be significant.

For a charge to be fixed (rather than floating), it is advisable for a lender to ensure that it exercises actual control over the charged assets so that the chargor is not permitted to freely deal with the assets as though they were not subject to the fixed charge. Otherwise, the security may be recharacterized as a floating charge. In practice, it is often difficult to take a fixed charge over inventory or trade receivables if they are trading assets of the chargor because the taking of a fixed charge is likely to be strongly resisted by a chargor.

Where security is taken over contractual rights, the underlying contract giving rise to the assigned rights must be examined to ensure that those contractual rights can be made the subject of security. Prohibitions on the assignment of those rights will invalidate any purported security over them. In addition, rights under contracts that are "personal" to the contracting parties (e.g., an employment contract) are not assignable.

In some cases, the involvement of a third party may be required before effective security can be granted. For example, it may be necessary to obtain a waiver or consent to the creation of the security from a contract counterparty.

In the case of land in Hong Kong, it is necessary to consider the land grant conditions to determine whether the grant of security over land is permitted or subject to any restrictions. The land grant conditions may prohibit the creation of security over the land (even where security is granted to finance the land acquisition cost) or may otherwise limit the persons to whom security may be granted. In addition, the land grant conditions in respect of certain Hong Kong real property may contain restrictions on alienation that require, for example, specific consents to be obtained from the Hong Kong government or a government-linked entity prior to security being created in favor of a lender. In those cases, the consent may limit the maximum amount that may be secured by the relevant security.

In the case of shares in a Hong Kong company, it is necessary to consider whether the articles of association of the company impose any restrictions on the grant of security over, or on the transfer of, those shares. The effectiveness of the security or a lender's rights to enforce that security may be compromised if the restrictions in relation to the transfer contained in the articles of association are not first altered or disapplied, or if any required consents are not obtained.

As a matter of public policy, generally, it is not possible to assign (by way of security) a bare right to sue or litigate.

## 9. Under the laws of this jurisdiction, are there any restrictions on offshore lenders taking security over any class of asset?

No, but see the responses to question 8 of this section (which would apply equally to an offshore lender wishing to take security).

## 10. Must a company receive a corporate benefit in return for giving a guarantee or security? In particular, are there restrictions on the grant of upstream and cross-stream guarantees and security? If yes, briefly what is the effect of these laws?

Directors of a Hong Kong company have a common law duty to act in the best interests of the company and to exercise powers and to take actions that benefit the company commercially. The Companies Registry of Hong Kong ("**Companies Registry**") has issued nonstatutory guidelines that outline general principles for directors in the performance of their functions that embody the requirement for directors to act in the best interests of the company.

When considering whether a company should provide a guarantee or security, the directors must therefore consider whether any commercial benefit will accrue to the company from the provision of that guarantee or security.

Generally, Hong Kong law does not recognize the concept of a group benefit. When a parent company gives a guarantee or grants security in respect of a subsidiary's obligations, the commercial benefit to the parent can be clearly established. However, when a subsidiary company gives a guarantee or grants security in respect of its parent's obligations or the obligations of another subsidiary of its parent (i.e., a "sister" company), it is often more difficult to establish what the commercial benefit is to the subsidiary.

Whether a company derives a commercial benefit from providing a guarantee or security is a factual matter for consideration in each particular case however, practical steps can be taken to reduce the risk of commercial benefit arguments being successfully raised by the most likely objectors (the company's shareholders and creditors). Assuming a guarantee or security is proposed to be granted by a solvent company, two key steps are obtaining the unanimous approval of the company's shareholders to the giving of the guarantee or the granting of the security and obtaining a statement from the company's directors that the company will not be unable to pay its debts as a result of the giving of the guarantee or the granting of the security. This will also protect the guarantee or security from being subsequently challenged as unenforceable on the basis that, for example, the directors used the powers conferred on them for an improper purpose or for a purpose not authorized by the company's articles of association (i.e., not in the best interests of the company), provided that the lender/chargee does not have actual knowledge of that impropriety.

Lastly, there are general presumptions in law that allow parties to presume that the transactions undertaken by a Hong Kong company are not *ultra vires* acts.

## 11. What type of security interests does your jurisdiction recognise, e.g., pledge, charge, mortgage, hypothecation? In relation to each type of security interest, please state the formalities required to create and perfect that security.

Types of security interests

The types of security interests typically used in financing transactions in Hong Kong include:

For shares, a legal or equitable mortgage or an equitable charge.

For real property, a legal charge.

For other immovable assets:
a fixed charge over specific assets.

For movable assets: a chattel mortgage, a floating charge, or a pledge - note that under Hong Kong law, a "pledge" is a "possessory security" and can only be created over movable assets, but not over immovable assets or intangible assets.

For bank accounts, book debts and contractual rights (such as rights to insurance and rights to trade receivables), an equitable or legal assignment, or a charge.

Generally, a floating charge over all or certain classes of assets.

Formalities

Security over specified assets of a company incorporated in Hong Kong or a company registered under the CO as a "non-Hong Kong company" must be registered with the Companies Registry within one month of the creation of the relevant security. Otherwise, the security will not be enforceable against any liquidator or creditor of the security provider.

In addition, in the case of a legal charge over real property or any other security document affecting land, the security interest must also be registered within one month of its creation with the Land Registry of Hong Kong ("**Land Registry**") to preserve its priority.

The registration of certain assets with other registries may also be necessary or advisable. See the answer to question 12 of this section for the registration requirements.

To perfect an assignment of debts and contractual rights, written notice of the assignment must be provided to the debtor or counterparty. For some classes of an asset (e.g., shares and other securities), it is common for lenders or security agents to hold in their possession and control any documents of title (e.g., title deeds), blank transfer forms and other ancillary documents (e.g., signed but undated resignation letters of the directors) to assist with the enforcement of the security and prevent unauthorized dealings by the chargor.

Security interests over real property must generally be made by way of deed and it is common for security over other kinds of assets to be made by deed.

## 12. Are there any registration, translation or notarization requirements in relation to security, guarantees, subordination or intercreditor documents?

If a document creates registrable security, it must be filed with the Companies Registry within one month of the date of its execution (and together with a certified translation, if the security document is not in Chinese or English). This registration requirement only applies to security created by companies incorporated in Hong Kong and any foreign company that is registered as a non-Hong Kong company (as referred to in the answer to question 11 of this section).

Where a foreign company (not a non-Hong Kong company) enters into a security document and the secured property is situated in Hong Kong, and the company subsequently becomes registered as a non-Hong Kong company under the CO, the registration of the security with the Companies Registry is required within one month of the date of the foreign company's registration as a non-Hong Kong company.

As mentioned in the answer to question 11 of this section, a legal charge over real property or any other security document affecting land must also be registered within one month of its creation with the Land Registry (and if the security document is not in Chinese or English, together with a Chinese or English translation to enable the Land Registry to determine whether the relevant registration requirements have been complied with).

Apart from the registration requirements referred to above, there may be different registration requirements in respect of certain types of assets (e.g., vessels and intellectual property) and in relation to different types of security providers (e.g., individuals).

There are no notarization requirements in relation to security, guarantee, subordination or intercreditor documents.

## 13. Are there any stamp, documentary, registration, notarization or other taxes, duties or fees chargeable in respect of security, guarantees, subordination or intercreditor documents? If yes, what are the amounts and when are they payable?

A registration fee of HKD 340 must be paid to the Companies Registry on the submission for the registration of each security document.

A registration fee of HKD 450 must be paid to the Land Registry on the submission for the registration of each security document (or HKD 230 if the amount or value of the consideration or value of the property or interest affected is less than HKD 750,000).

Other than the registration requirements and fees set out above and in the answer to question 12 of this section, no stamp duty or similar taxes or charges are payable in respect of security documents. However, in respect of a mortgage of shares in a Hong Kong company, nominal stamp duty of HKD 5 is payable on the execution of an instrument of transfer signed "in blank" (which lenders normally require). The execution enables the shares to be registered in the name of the lender (or its nominee) by converting an equitable share mortgage into a legal share mortgage. Stamp duty at a rate of 0.26% of the value of shares being transferred will be payable on the enforcement of the security. After the execution of an agreement for the transfer of shares, the parties should submit the relevant documents for stamping, if that agreement is executed in Hong Kong, within two days of signing; if it is executed outside Hong Kong, within 30 days of signing.

# If things go wrong

## 1. Please provide a brief description of the insolvency regime. In particular what rights and duties do unsecured and secured lenders have on the insolvency of a debtor? Are there any other matters of concern?

Insolvency regime

There are three types of liquidation in Hong Kong: a members' voluntary liquidation, a creditors' voluntary liquidation and a compulsory liquidation.

A members' voluntary liquidation can be commenced only where the company is solvent. The directors must sign a certificate of solvency stating their opinion that the company will be able to pay its debts in full within a period not exceeding 12 months from the commencement of the winding-up. Then, the shareholders pass a special resolution to place the company into voluntary liquidation.

A creditors' voluntary liquidation occurs where the shareholders pass a special resolution to place the company into voluntary liquidation and where the directors have not signed a certificate of solvency. The resolution is usually passed on the basis that the company cannot continue its business because of its liabilities. A creditors' meeting is also required.

A compulsory liquidation occurs where a company is wound up by an order of the court. A company may be wound up by the court on a number of grounds, most often in an insolvency situation because it is unable to pay its debts. There is also a broad discretionary power under which the court can order a company to be wound up where it is just and equitable to do so. The application submitted to the court to wind up a company may be made by a creditor, a shareholder or the company itself. This is done by way of a winding-up petition.

Unsecured creditors

An unsecured creditor must prove its debts in a liquidation by submitting a proof of debt form to the liquidator.

After the liquidator has received all the proof of debt forms from the creditors, the liquidator will assess each of the claims and decide whether to admit each proof. If the liquidator considers a claim unenforceable, the liquidator can reject the claim and put the onus of proving the debt back on the creditor.

Assuming that there are sufficient assets available to enable the liquidator to make a distribution to the creditors of the company, the liquidator must make a distribution in accordance with the order prescribed by legislation. Generally, the order of distribution is as follows:

Secured creditors — assets of the company under security will be realized to pay off secured creditors first, with any excess proceeds distributed according to the subsequent priority below.

Expenses of the liquidation, including liquidator's fees.

Preferential payments (usually employees' wages and statutory debts due to the government).

Floating charge holders.

General unsecured creditors.

Members/shareholders of the company.

If there are insufficient assets to be distributed to pay a class of creditors in full, the general principle of *pari passu* distribution (i.e., all creditors of the same class rank equally in a winding-up) applies.

Statutory insolvency set-off applies to unsecured debts. Where before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming in the liquidation, an account must be taken of what is due from each party to the other and the sums due from one party are set off against the sums due from the other; only the balance can be proved in the liquidation. Statutory insolvency set-off is mandatory in a liquidation and it cannot be contracted out of.

Secured creditors

A secured creditor (e.g., a creditor holding a mortgage, charge or lien) is entitled to enforce its security despite the making of a winding-up order. It can rely on its security and need not prove in the liquidation if the security is worth the same as, or more than, the debt owed.

If the creditor is undersecured, it can realize the security and prove for any balance or waive the security and prove for the entire debt.

Guidelines issued by the HKMA and the Hong Kong Association of Banks

The HKMA and the Hong Kong Association of Banks have issued nonstatutory guidelines as in relation to how institutions should deal with borrowing customers in financial difficulties where the borrower is dealing with multiple banks. Banks are encouraged to opt first for a workout (a private contractual arrangement to assist a company in financial difficulty).

## 2. Is it possible to obtain a moratorium before insolvency?

There is no formal moratorium available to an insolvent company on the presentation of a winding-up petition. However, in practice, the period between the presentation of a winding-up petition and the creation of a winding up-order provides a moratorium period (otherwise unavailable under the current legislative regime) in which to conduct restructuring negotiations. The reason for this is that once a winding-up petition is presented, the insolvent company (and any creditor and person obliged to contribute to the assets of the company) can apply to the court for a stay of proceedings.

Once a winding-up order has been made or a provisional liquidator appointed, no action or proceeding can commence or continue except by leave of the court.

In 2020, the Hong Kong government announced its intention to introduce the Companies (Corporate Rescue) Bill ("**Bill**") in the Legislative Council at a date to be confirmed. The Bill was aimed at introducing a statutory corporate rescue procedure in Hong Kong, which would involve the appointment of an independent professional third party (a certified public accountant or solicitor) as a provisional supervisor of a company in financial difficulty. The provisional supervisor would displace the directors and management of the company and act as its agent during the period of provisional supervision (proposed to be set at 45 business days), during which the company would continue to operate as a going concern. There would be a moratorium on civil proceedings and actions against the company and its property during this period. As a protective measure for secured creditors, one of the proposed requirements to commence provisional supervision was that a person holding charges on the whole or substantially the whole of the company's properties (the major secured creditor) would not object to the provisional supervision within a specified period upon being notified of the provisional supervision. However, as of the date on which this guide has been published, the Bill had not yet been tabled in the Legislative Council.

It remains to be seen whether and, if so, in which form the Bill will be enacted and take effect.

## 3. When a company is the subject of a formal insolvency procedure, can the company’s pre-insolvency transactions be set aside?

Pre-insolvency transactions

Yes. In all forms of liquidation, a liquidator has the power to investigate the affairs of a company and seek redress from the court if it considers that assets belonging to the company have been dissipated. Some examples of possible areas that liquidators may investigate are set out below.

Unfair preference

A liquidator may challenge any creditor that received a payment from the company and may have been preferred against other creditors within six months of the commencement of the liquidation. The six-month period is extended to two years in the case of payments to a person connected with the company, which is broadly defined.

Disposition of property with the intent to defraud creditors

A disposition of property with the intent to defraud creditors is voidable at the behest of the person prejudiced by the disposition, except if the property has been disposed of for valuable consideration and in good faith to any person who has not been notified, at the time of the disposition, of the intent to defraud creditors.

Transactions at an undervalue

A court may set aside a transaction at an undervalue entered into within five years before the commencement of the liquidation. A transaction at an undervalue includes transactions that result in the company receiving consideration that is significantly less than the value provided by the company.

Disposition after the commencement of a compulsory liquidation

A disposition after the commencement of a compulsory liquidation is void and the recipients of these funds or assets must return them to the liquidator unless a validation order has been made by the court. A validation order is an order by which the court ratifies the relevant disposition of property.

Fraudulent trading

Where the business is carried on with the intent to defraud creditors or for any other fraudulent purpose, the persons who were knowingly parties to the carrying on of the business may be personally liable for the debts of the company.

Misfeasance

Where directors have breached their duties to the company or have misapplied or retained property of the company for their personal benefit, they may be ordered to repay or restore the money or property, or pay compensation to the company.

Insolvent trading

While fraudulent trading is prohibited, no legislation in Hong Kong prohibits insolvent trading or the incurring of a debt by a company at a time when it is unable to pay its debts as they fall due, although the liquidators may bring an action against the directors for the breach of their duties. The Hong Kong government is considering implementing provisions in relation to insolvent trading.

## 4. When can a lender enforce its security? Can security be enforced out of court following an event of default (or other contractual trigger event), or is a court order required? Are there any restrictions that apply before a lender may enforce its security?

Theoretically, a lender can enforce its security at any time; the precise time depends on the terms of the security document or other agreement between the lender and the borrower (e.g., as soon as the borrower is in default). However, the lender should give the debtor sufficient time to enable it to effect payment before enforcing the security.

Generally, there is no requirement to obtain a court order to enforce security. However, in respect of a mortgage over real property, a lender can bring a "mortgagee action" to obtain a court order for the payment of monies secured by the mortgage and for possession of the mortgaged property, among other things. Alternatively, a lender can enforce a mortgage by virtue of express or implied powers under the mortgage or powers implied into the mortgage by the Conveyancing and Property Ordinance.

Note that foreclosure of a mortgage (i.e., extinguishing a mortgagor's right to redeem (recover) the mortgaged asset on repayment of the secured debt) is only possible with a court order.

## 5. Do any limitation periods apply in relation to bringing an action to enforce security?

An action in simple debt is normally governed by the six-year limitation period for actions in contract and tort as stipulated by the Limitation Ordinance. The limitation period begins from the date on which the cause of action first accrues.

The Limitation Ordinance also provides that no action is permitted to be brought to recover any principal sum of money secured by a mortgage or other charge on property, or to recover proceeds of the sale of land, after the expiration of 12 years from the date when the right to receive the money accrued.

## 6. Is there any particular way in which secured assets must be liquidated on enforcement (e.g., by auction or court sale)?

There are no specific legal requirements on how secured assets must be liquidated on enforcement. Some relevant steps, however, in relation to the enforcement of security over real property, shares and movable assets are set out below.

Real property

A mortgagee must comply with its duties on the sale of the asset by acting in good faith and taking reasonable steps to obtain a proper price for the mortgaged property. Practically, this is usually done by way of an auction.

Foreclosure, which results in the lender becoming the absolute owner of the charged property, requires a court order.

Shares

Security over shares can generally be enforced without a court order. Depending on the terms of the security document, a lender usually has the right to sell the shares and exercise all the voting rights attached to the shares.

Movable assets

Movable assets secured by way of a fixed or floating charge are often realized by appointing a receiver to take physical possession of the assets and sell them. Usually the document creating the charge sets out the method of enforcement.

## 7. Are there any particular legal or practical difficulties or delays in enforcing security?

A debtor may resist the lender's attempt to enforce security, often by disputing the debt itself or by questioning the validity of the document creating the security. This often causes delays in enforcing the security.

## 8. In relation to enforcement, are there any specific requirements to be borne in mind if the lender is a foreign entity?

If a foreign entity that neither resides nor carries on business in Hong Kong brings proceedings to enforce security, the defendant may apply for security for costs of the action to be paid in court. The amount to be paid is generally an estimate of the defendant's costs in defending the action brought by the foreign entity. The court has discretion in relation to whether to grant this type of order, having regard to all the circumstances, including the plaintiff's prospects of success. However, security for costs is usually not required if the foreign entity has substantial property of a fixed and permanent nature within Hong Kong.

## 9. Is there any reason why you think that arbitration rather than litigation might be advantageous in resolving disputes under the finance documents, and if so, why? Please outline the relative merits of arbitration and litigation, including the ease of enforcement of foreign judgments and foreign awards from different jurisdictions. Is it possible to rely on a hybrid enforcement provision that allows the lenders to opt for either arbitration or litigation as they see fit?

Confidentiality

Arbitration proceedings are typically private and confidential. By contrast, court proceedings are open to the public and the judgments are public documents. Parties normally opt for arbitration if the dispute is commercially sensitive.

Procedural matters

The arbitral tribunal can conduct the arbitration in the manner that is most efficient and expeditious without being bound by local court procedural rules. A common example is that the rules of evidence are not generally applicable in arbitrations.

Court hearings are governed by a fixed set of procedural rules. This may offer certainty to the parties over the more flexible but uncertain procedures in arbitration and, in some cases, can reduce delay in the proceedings.

Summary procedure

Under Hong Kong court rules, there is a summary judgment procedure for obtaining judgment in cases where there is no dispute about the facts. While institutional arbitration rules commonly used in Hong Kong allow an arbitral tribunal to decide points of law or fact in an early determination procedure, a summary judgment is not available in arbitration. As disputes under finance documents usually do not involve complex factual issues, the lack of a summary judgment procedure could increase time and costs in an otherwise straightforward case.

Enforceability

An arbitral award rendered in Hong Kong can be enforced in over 170 party states to the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards, including most of the major business centers, as well as in Mainland China.

A foreign court judgment is enforceable by way of registration or under the common law if certain requirements are fulfilled. If the judgment is entered in Mainland China, the judgment may be enforced under the relevant Hong Kong Ordinance implementing the applicable Hong Kong/Mainland China arrangement on reciprocal recognition and enforcement of judgments. The existing arrangement under the Mainland Judgments (Reciprocal Enforcement) Ordinance (Cap. 597) ("**Old MJREO**”) will be replaced effective 29 January 2024 by the new Mainland Judgments in Civil and Commercial Matters (Reciprocal Enforcement) Ordinance (Cap. 645) (“**New MJREO**”). However, the Old MJREO will continue to apply in certain cases even after the New MJREO has taken effect.

Appeals

Unlike litigation, there is generally no right of appeal in arbitration, unless the parties expressly agree on a right of appeal. Even in those circumstances, the right of appeal is limited.

Costs

While arbitrations require parties to pay the costs of the arbitral institution and arbitral tribunal whereas there is no or minimal costs in using the public court facilities in litigation, the cost difference between arbitration and litigation (in terms of legal fees) is usually not significant.

**Hybrid enforcement**

It is possible to adopt dispute resolution provisions that allow lenders to opt for either arbitration or litigation as they see fit.

## 10. Are asymmetrical jurisdiction clauses enforceable? (By this we mean clauses that allow the lenders, but not the borrowers, to make certain choices in relation to choice of jurisdiction and how to litigate. These types of clauses allow the lenders, but not the borrowers, to commence proceedings in any court they choose, but restrict the borrowers to commencing proceedings in one jurisdiction only. This may also allow the lenders, but not the borrowers, to choose whether to litigate the finance documents before a court or to submit to arbitration in relation to them, but restrict the borrowers to either litigation or arbitration, as specified in the agreement).

Hong Kong courts generally give effect to the contractual agreement of the parties, save in exceptional circumstances.

There is one case where a Hong Kong court held that a clause that gave only one of the parties the right to refer a dispute to arbitration was within the meaning of an "arbitration agreement" of Article 8(1) of the UNCITRAL Model Law (*China Merchants Heavy Industry Co Ltd v. JGC Corp* [2001] 3 HKC 580). More recent authorities further support the proposition that Hong Kong courts accept asymmetrical clauses.

While an asymmetrical jurisdiction clause is likely to be enforceable in Hong Kong, there may be additional considerations when the party with the option to choose the jurisdiction (i.e., usually the lender) wants to enforce a judgment in Mainland China through the Old MJREO, where the underlying contract contains an asymmetrical jurisdiction clause. Under the Old MJREO, to enforce the Hong Kong judgment Mainland China, the Hong Kong court needs to have exclusive jurisdiction, as agreed by the parties to the underlying contract. In *Industrial and Commercial Bank of China (Asia) Limited v. Wisdom Top International Limited* [2020] HKCFI 322 (which was followed in *TransAsia Private Capital Ltd v. Cheng Yu* [2022] HKCFI 1295), the Hong Kong court held that an asymmetrical jurisdiction clause is not an exclusive jurisdiction clause and so a judgment based on such contract would not be enforceable in Mainland China under the Old MJREO.1

1 However, as indicated in the response to question 9 (under “Enforcement”), the New MJREO will take effect on 29 January 2024, in order to implement the new arrangement entered into by Hong Kong and Mainland China (the "Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters between the Courts of the Mainland and of the Hong Kong SAR" of 18 January 2019 ("**2019 Arrangement**")). Under the 2019 Arrangement, the requirement that the judgment needs to be from a court with exclusive jurisdiction is abolished.

# Working digitally

## 1. Is it possible for documents to be executed electronically (whether by the manual insertion of a digital signature or the use of an e-signing platform) under the laws of this jurisdiction? If so, is this limited to only particular types of finance documents?

Yes, it is generally possible for documents to be executed electronically under the laws of Hong Kong, subject to certain restrictions under the Electronic Transactions Ordinance (ETO).

Schedule 1 to the ETO sets out certain categories of documents to which the relevant provisions of the ETO do not apply, for example, they require wet ink signatures or physical execution. Primarily relevant in the context of secured lending are documents creating, executing, varying or revoking an express trust or a power of attorney (including documents containing such trust/power of attorney provisions), Hong Kong land-related security documents and contracts assigning or otherwise disposing of an interest in immovable property in Hong Kong.

Charges created by companies that are registrable under the CO would generally also require physical execution. Security over particular types of assets (such as intellectual property, aircraft, vessels, etc.) may be subject to registrations with specialized registries. Whether the relevant security document can be executed electronically will depend on the specific registration requirements applicable in each case.

Special registration requirements apply for certain charges granted by individuals, which may require the security document to be executed in a physical written form.

In transactions involving government entities, a signature requirement under the law can only be satisfied by a "digital signature" supported by a recognized digital certificate issued by a certification authority recognized under the ETO. This requirement does not apply to transactions with parties that are not government entities.

## 2. Where the witnessing of a signing is contemplated, is it possible for the witness to verify the signature over a live video call?

Pending further clarification by legislation and case law, generally, it is prudent to assume that a witness must be physically present.

## 3. Is it possible to register/perfect security electronically without wet ink signatures?

It is possible to submit documents relating to charges and the release of charges to the Companies Registry for registration in an electronic form (and to sign the relevant Companies Registry form without wet ink signatures), provided that, among other things, appropriate user accounts are opened with, and the relevant passwords or digital certificates are "registered" with, the Companies Registry's e-Registry. However, normally, it is not feasible to electronically submit the registrable security document itself to the Companies Registry (e.g., because they typically include a power of attorney and other provisions that cannot be executed electronically by virtue of Schedule 1 to the ETO). Please see the Companies Registry's website for more guidance.

## 4. Are there any other legal restrictions that may prevent the parties from executing a finance transaction electronically?

No.

# Contributors

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