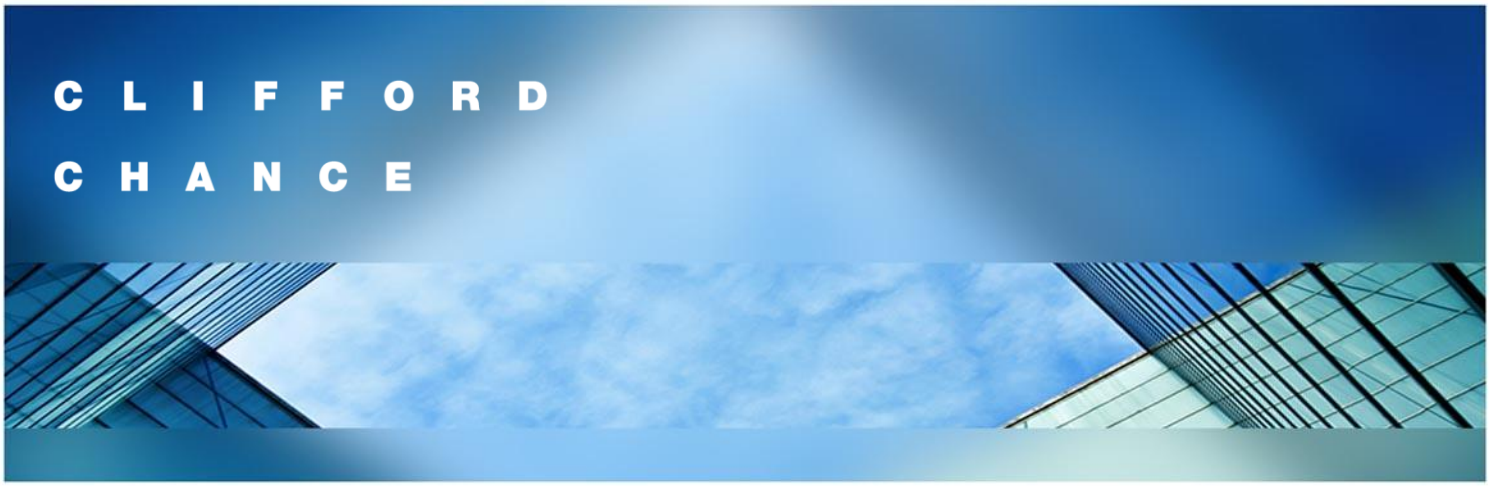

ENFORCEMENT OF DEBT SECURITIES IN A GLOBAL NOTE STRUCTURE - TESTING THE “NO LOOK THROUGH” PRINCIPLE

Investors of debt securities in a global note structure may face obstacles in directly enforcing against the relevant issuers at times of default, not least because only the holder of the global note has standing to enforce against the relevant issuers before the global note is converted into definitive notes to be registered in the names of individual or discrete investors. Contractually, each party typically only has rights against its own counterparty (referred to in the case law as the "no look through" principle). The issuers in default, however, may be uncooperative in procuring such conversion. In the Hong Kong case, *China Ping An Insurance Overseas (Holdings) Ltd v. Luck Gain Ltd and Others*[1], despite the applicability of the “no look through” principle, the Hong Kong court allowed a discrete investor to rely on a separate subscription agreement with the issuer to compel such conversion and directly enforce against the issuer. Whilst this case was decided on its specific facts and contractual terms, it sheds light on the operation of the "no look through" principle in practice.

Key issues

- By operation of the “no look through” principle, individual or discrete investors do not have standing to enforce their interest in debt securities in a global note structure directly against the relevant issuer. This is because only the holder of the global note has standing to enforce against the issuer unless the global note can be converted into definitive notes registered in the names of discrete investors. Similarly, this is unless the global note can be converted into definitive notes in bearer form held by discrete investors.
- Notwithstanding the applicability of the "no look through" principle, the Hong Kong court may compel an issuer to convert a global certificate to definitive certificates by specifically enforcing a separate subscription agreement directly entered into between the issuer and an investor.
- This briefing also explores other avenues by which investors may directly enforce against the relevant issuer.

INTRODUCTION

In international capital markets, bonds are typically issued by an issuer in the form of a global note whereby a custodian holds the global note on behalf of a clearinghouse (such as Euroclear or Clearstream). The clearinghouse, in turn, maintains accounts for members (including banks and other financial institutions) which hold and deal in interests in those bonds, being fungible in nature, and tradeable between account holders through electronic book entries. The account holders may hold such interests for themselves as principal or to the order of their customers who are the ultimate individual or discrete bondholders.

[1] [2023] HKCFI 3315

The system typically operates based on the "no look through" principle, whereby each party only has rights against its own counterparty. In other words, discrete bondholders' recourse is only against the account holder in the clearing system, as opposed to the issuer of the bonds.

Despite the attempt to rely on the "no look through" principle, in the judgment of *China Ping An*, the court enabled direct recourse by a bondholder against the issuer and the guarantor. This was by way of the Hong Kong court granting summary judgment to the plaintiff bondholder (the "**Bondholder**") and ordering specific performance to compel the issuer (the "**Issuer**") and the guarantor (the "**Guarantor**") to exchange the global certificate for definitive certificates registered in the name of the Bondholder. This creates a direct relationship between the Bondholder on the one hand and the Issuer and the Guarantor on the other, which enables the Bondholder to sue the Issuer and the Guarantor directly and/or present a winding-up petition against them.

Notably, the Bondholder relied on a clause in the Subscription Agreement entered into between the Bondholder on the one hand, and the Issuer and the Guarantor on the other, which, in effect, requires the Issuer and the Guarantor to make satisfactory arrangement to the Bondholder to ensure that the certificates (i.e. the global certificate and the definitive certificates) be delivered to the registrar for authentication in accordance with the Agency Agreement (which is part of the bond documentation as defined below). In the event of default by the Issuer and the Guarantor, such contractual nexus enables the Bondholder to become a registered holder of the bonds by having definitive certificates registered in its own name.

This decision is significant to bondholders and trustees as it tests the limits of the "no look through" principle. The issuer is not immune from action brought by the ultimate bondholders if the bondholders are able to rely on separate and direct contractual documentation between them. In this case, the Subscription Agreement entered into between the Issuer and the Bondholder created a direct contractual nexus, allowing the Bondholder to have a direct cause of action against the Issuer to compel the exchange of the global certificate into definitive certificates.

Further, this decision also reflects the robust approach taken by the Hong Kong court in granting summary judgment notwithstanding the complexity of the contractual structure (and the amount involved).

FACTS AND REASONING OF THE CASE INCLUDING BACKGROUND TO STRUCTURE ADOPTED

The bonds in question were issued using a fiscal agency structure constituted by, among other things:

- a Deed of Covenant executed by the Issuer;
- a Fiscal Agency Agreement (the "**Agency Agreement**") made between the Issuer, the Guarantor, and the registrar (which was also the transfer agent and fiscal agent); and
- a global certificate registered in the name of a custodian or nominee on behalf of the clearinghouse of the bonds.

The Bondholder was not the account holder in the clearinghouse, instead holding its beneficial interest in a portion of the bonds through another bank, which was an account holder in the clearinghouse.

Under a Subscription Agreement, the Bondholder subscribed for US$200 million in aggregate principal amount of guaranteed bonds. The Subscription Agreement provided that the bonds would be represented by a global certificate, which would be exchangeable for definitive certificates in the circumstances specified in the global certificate. The Issuer was required to ensure that the global certificate and definitive certificates would be delivered to the registrar for authentication in accordance with the Agency Agreement and take all necessary actions to procure clearance of the bonds. The Agency Agreement similarly provided that if definitive certificates are required to be delivered, the Issuer shall promptly arrange for a stock of definitive certificates that are duly executed but unauthenticated to be made available to the registrar.

The global certificate provided that it would be exchanged for definitive certificates if an event of default occurred including the failure to pay the principal amount of or any interest on the bonds when due and payable.

Despite the expiry of the maturity date of the bonds, neither the Issuer nor the Guarantor paid the principal amount due and owing on the bonds. Requests to convert the global certificate into definitive certificates remained unanswered.

In such an event of failure to deliver definitive certificates to the Bondholder, the global certificate provided that it is the account holder in Euroclear, being another bank, as opposed to the Bondholder, who would acquire direct rights against the Issuer in accordance with the Deed of Covenant. The Bondholder thus initiated this legal action against the Issuer to compel the exchange of global certificate for definitive certificates in order to acquire direct rights for itself.

In granting summary judgment and ordering specific performance for exchange of the global certificate for definitive certificates in favour of the Bondholder, the court considered the Issuer's and the Guarantor's arguments and found there to be no arguable defence. The key points from the court's reasoning are summarised below:

- The Subscription Agreement provides for rights on the part of the Bondholder separate and independent from the direct rights on the part of the account holder under the bond documents including the Deed of Covenant. This is because the Subscription Agreement and the bond documents deal with different parties which are governed by different contractual relationships.
- From an ordinary and plain reading of the words of the Subscription Agreement, which are clear, and must be given full effect, the Issuer and the Guarantor owe the Bondholder the obligation to ensure the definitive certificates are delivered to the registrar for authentication. The Subscription Agreement may require the Issuer and the Guarantor to comply with the Agency Agreement, notwithstanding that the Bondholder is not a party to the Agency Agreement, and the same document excludes a third party, including the Bondholder, from relying on its provisions.
- Despite having the provision providing for a direct right on the part of the account holder in the Deed of Covenant and the global certificate, it does

not preclude the Bondholder from having a separate and independent right against the Issuer and the Guarantor. Duplicity of action is a "natural consequence" of having different contracts governing different parties.

- The reliance on the "no look through" principle does not assist the Issuer and the Guarantor because it is due to the restraint imposed by the principle that the Bondholder has to apply to compel the exchange of global certificate into definitive certificates in its name in reliance of the Subscription Agreement.
- The bonds do not cease to be fungible by reason of the Bondholder enjoying rights against the Issuer and the Guarantor which are not available to the other investors on the basis that such rights arise from a separate Subscription Agreement between the Bondholder and the Issuer and the Guarantor.

IMPLICATIONS TO INVESTORS OF DEBT SECURITIES IN A GLOBAL NOTE STRUCTURE

This decision is an example where the investor had direct recourse to the issuer by enforcing the Subscription Agreement between them despite the attempt to rely upon the "no look through" principle to exclude such recourse. From an investor's perspective, as a practical matter, the account holder (typically banks or other financial institutions) may be unwilling to enforce against an issuer on its behalf, or otherwise may demand commercially unfavourable conditions, such as broad indemnities and upfront pre-funding. In this context, here are some of the potential ways in which an investor may take matters into its own hands and advance a direct claim against an issuer:

1. **Non-contractual claims**: An important caveat of the "no look through" principle is that it does not suggest that a claim in tort or any statutory action, if sustainable, would similarly be barred. For instance, it remains open for an investor to allege any misrepresentation in an issuer's offering documents. In the UK, for example, the court has held that the ultimate investor is not precluded from bringing a claim against an issuer under section 90 (compensation for statements in listing particulars or prospectus) or section 90A (liability of issuers in connection with published information) of the Financial Services and Markets Act 2000 notwithstanding the existence of an intermediated securities structure.[2] Similarly, in Hong Kong, an investor may consider relying on, among others, sections 108 (civil liability for inducing others to invest money in certain cases), 277 (disclosure of false or misleading information inducing transactions) and 281 (civil liability for market misconduct) of the Securities and Futures Ordinance (Cap. 571) and section 40 (civil liability for misstatements in prospectus) of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) for false, incomplete or misleading information in an offering document.
2. **Assignment of direct right from an account holder**: In the case of *Re Jinro (HK) International Ltd (No 2)*[3], the investors purchased the bonds in the Euroclear system after the issuer had already defaulted and the account holder had procured direct rights. Given a clause in the deed of

[2] See *SL Claimants v Tesco plc; MLB Claimants v Tesco plc* [2020] Bus. L.R. 250 at [119].
[3] [2003] 4 HKC 637

covenant that provided that the deed shall enure to the benefit of each accountholder and its successors and assigns, the court found that the investors fell within the definition of "successors and assigns" and constituted creditors, having standing to petition for winding-up. The primary defence raised in this case was that there could be no trading in the Euroclear system after default as the bonds had exited the system, rather than any reliance on the "no look through" principle. That said, an enurement clause binding the issuer vis-a-vis discrete investors may be another way to acquire direct rights.

3. **Third party rights**: Whilst an enurement clause in effect binds third parties, it is otherwise standard for bond documents to exclude third party rights; the application of the Contracts (Rights of Third Parties) Act 1999 (in the case of English law governed documents) or Contracts (Rights of Third Parties) Ordinance (Cap. 623)[4] (in the case of Hong Kong law governed documents) is normally excluded. However, if such standard exclusion has not been included in the bond documentation, it is open for an investor to argue that it may enforce any third party right by relying on the relevant statute.

4. **Individual or discrete bondholder as contingent creditor**: The courts in different jurisdictions including Hong Kong, Cayman Islands and BVI have come to different conclusions on the standing of an ultimate investor to bring a winding-up petition against the issuer as a contingent creditor, albeit there are arguably distinguishable facts to explain the differences. In Hong Kong, for an investor to qualify as a contingent creditor, the current position is that applying the "no look through" principle, an existing direct contractual relationship or obligation as between the issuer and the investor is required to ground a winding-up petition against the issuer.[5] The Cayman Islands[6] court has taken a similar position. On the other hand, the BVI court has taken a contrary position.[7] In the *Cithara* case, the BVI court held that a contractual relationship is not necessary so long as the debtor is required to take certain steps that would make it liable to the creditor. In this regard, the issuer's obligations to authenticate and deliver definitive notes to the beneficial holders when a note has become immediately due and payable may be sufficient.

   The difference between, on the one hand, Hong Kong and Cayman Islands courts, and on the other hand, the BVI court, in principle, lies in the definition and meaning of "contingent creditor" in the winding-up context and the applicability of the case law regarding schemes of arrangement (which is arguably less draconian and what is at stake is different):

   a. Traditionally, in the UK, in order to have standing as a "contingent creditor" to petition for winding-up, it has to be shown that the company is subject to an existing obligation towards the petitioner, under which the company may or will become subject to a liability

[4] For more, see our briefing here
[5] *Re Leading Holdings Group Ltd* [2023] 4 HKLRD 71
[6] *Re Shinsun Holdings (Group) Co., Ltd* (unreported, FSD 192 of 2022 (DDJ), 21 April 2023)
[7] *Cithara Global Multi-Strategy SPC v Haimen Zhongnan Investment Development (International) Co. Ltd* (Claim No. BVIHC(COM) 2022/0183)

upon the happening of a future event.[8] On the other hand, in the context of entitlement to vote at a meeting to approve a scheme of arrangement, the meaning and scope of "contingent creditor" was expanded in a more recent case, in which it was held that such existing obligation between the company and the person claiming to be a contingent creditor is not required.[9] It remains uncertain whether the expansion will (or should) apply in the winding-up context, albeit the direction of the case law has the potential to shrink if not eliminate the "no look through" principle in the global note structure, as its practical effect is that a petitioner may leapfrog its counterparties and directly pursue the issuer.

b. In the *Cithara* case, the decision reached by the BVI court can in large part be explained by the adoption of the meaning of contingent creditor used in the UK scheme of arrangement context, and arguably, this is only appropriate given the wider definition of creditor in the BVI insolvency law. On the other hand, in both the Cayman Islands *Shinsun* case and Hong Kong *Leading* case, it was considered inappropriate to apply the law in relation to schemes of arrangement to winding-up.

Further, there are arguably distinguishable facts that explain the decisions in different jurisdictions. For example, in the *Cithara* case, there was no question that the debt was owing; on the other hand, in the Cayman Islands *Shinsun* case, there was a question as to validity of the acceleration notice. Further, in the *Cithara* case, the court considered Euroclear's operating procedures and found the investor to have been authorised by Euroclear to bring the proceedings, whereas the investor in the *Shinsun* case was found not to have been duly authorised by Euroclear to progress the winding-up proceedings.

This means that the ability of an investor to wind up an issuer is subject to various complexities arising from: (i) the contractual documentation; (ii) the factual matrix; and (ii) the law of the forum (winding-up will commonly be sought in the issuer's place of incorporation) as it affects standing to present a winding-up petition and whether the issuer meets the relevant definition of contingent creditor.

CONCLUSION

For investors to have direct recourse against the issuer, they should negotiate and ensure the contractual documentation is designed to expressly reflect such intention to avoid any dispute in this regard. If not, they may be forced to navigate the intricacies of non-contractual (including tortious or statutory) claims, and otherwise differing law in differing jurisdictions depending on the relief they are seeking (whether court proceedings, winding up or voting at a scheme of arrangement). The factual circumstances will also be a factor in the availability of direct recourse.

[8] *Re William Hockley Ltd* [1962] 1 WLR 555
[9] *Re Nortel GmbH* [2014] AC 209

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