project will require a substantial overdraft facility. However, a substantial limit granted to a single borrower will produce complications in fund management as a lender is only in a position to negotiate its overdraft limit; once that limit has been agreed and within that limit, the borrower regulates itself without reference to the lender. Thus, unexpected substantial drawing by a borrower can embarrass a lender's liquidity. More importantly, a lender may wish to monitor the disbursement of the loan by requiring, for example, the drawing of the loan to be made against presentation of the architect's or engineer's certificate as to the progress of the project. An overdraft facility may not conveniently suit a monitoring procedure intended by the lender.

(3) Bullet instalment loan

A loan can take the form of a lump sum (a 'bullet') which will be repaid by the borrower of the number of instalments agreed. There is one obligation of the lender, which is to lend the bullet loan. The borrower's obligation is to repay on the due days of each instalment. Whether the borrower can repay in advance (ie prepay) depends on the terms of the loan agreement. Usually, any prepayment requires the payment of a fee since there is a loss of profit to the lender.

Occasionally, for a small project a bullet instalment loan may be agreed. However, a bullet loan does not facilitate the lender to monitor the progress of the project. Once the loan has been disbursed, its control of its use rests with the borrower. It is not acceptable to the Government under the Consent Scheme.

(4) Term loan

(a) Features

A term loan is a facility under which a lender commits to lend to the borrower during an agreed period of time if certain conditions are fulfilled. The amount of each loan will be agreed on the loan agreement and is to be drawndown by the borrower serving a notice in advance to the lender. Until the borrower serves the notice, the lender is not under an obligation to the borrower. The lender, however, is committed to lend if a proper notice has been served and the conditions for each advance have been fulfilled. In other words, the borrower is granted an option to borrow.

A notable feature of a term loan is the concept of match funding. Each advance drawndown by the borrower has to specify each interest period. The lender then accepts a matching deposit of the same amount and for the interest period from a depositor. This deposit is

then on-lent to the borrower at a margin above the deposit interest rate. The margin is agreed in the loan agreement. Of course, the lender may provide the matching deposit out of its own funds. The terms of a term loan agreement are designed to protect this match funding. This type of loan has a number of attractions both to the lender and to the borrower.

It confers on a borrower greater contractual certainty as to the availability of finance as the loan can no longer be called in on demand in the absence of any default on the part of the borrower. Further, a term loan has flexibility as the facility is normally drawn down in tranches as and when the borrower gives notices of drawdown or of borrowing. This is particularly attractive where the market for the sale of the flats in the building project is expected to be booming. The deposits and part payments made by the purchasers of the flats before completion of the project may be used to finance the construction. Where such deposits and part payments are substantial, the developer has the option not to draw on the facility. A term loan can therefore function as a standby fund to a borrower without the obligation to make interest payments until the loan is actually utilized.

A term loan also suits a lender. The periodic drawing of the loan against the satisfactory evidence of completion of stages of the building project enables the lender to check the progress of the project and to have a constant assessment of the finance. Thus, for most building projects, term loans are most frequently arranged for between the parties.

(b) Tranches in a project

Typically, a term loan in a building project will have two tranches, the acquisition tranche and the construction tranche.

The acquisition tranche is used to pay for the acquisition cost of this project site. It is usually to be drawn in a lump sum before the drawing on the construction tranche commences.

Often if a developer bids in an auction or tender of a site from the Government, it will arrange a bridging facility as it is unsure if its bidding is successful. In such a case, the acquisition tranche may be utilised to pay off the bridging facility.

For a large scale project, the interests payable on the acquisition and construction tranches may be very sizable. As the cash flow of a project remains tight until its completion, the borrower may not be able to meet its obligation to make periodic payment of interest. The lender may arrange a third separate tranche to finance the payment of such interests. This, in effect, is capitalising the interest payment. This aspect is discussed in paragraph 7.4 below.

5.2 The contractual obligation of the lender

In a loan agreement for a building project, a lender is obliged to make the loan facility available to the borrower unless there are defaults (as defined in the agreement) on the part of the borrower.

If the lender fails to make available the facility in accordance with its contractual obligation, the court will not grant an order of specific performance compelling it to do so. The remedy of an order for specific performance is not normally available to a loan contract (*Sichel* v *Mosenthal* (1862) 30 Beav 371; *The South African Territories Ltd* v *Wallington* [1898] AC 309; *Re Smelting Corporation* [1915] 1 Ch 472). However, where the loan is made available by a series of notes, which is extremely unusual in building project loans in Hong Kong, section 78 of the Companies Ordinance may apply. Under this section, a contract with a company to take up and pay for any debentures (as defined) may be enforced by an order of specific performance.

Although the remedy of specific performance is not normally available, a borrower may claim damages from the lender. Modern judicial precedents suggest that a contract for loan is subject to the usual contractual principles of assessing damages. The damages awarded to a borrower would be those arising naturally from the breach and those that may reasonably be supposed to have been in the contemplation of both parties at the time the contract is made (*Hadley* v *Baxendale* (1854) 9 Exch 341). Possible heads of special damage may include the following.

(a) Expenses reasonably incurred by the borrower in procuring the loan elsewhere may be claimed as special damage provided that it was caused by the breach of the lender and was within the contemplation of the parties (*Prehn* v *The Royal Bank of Liverpool* (1870) LR 5 Exch 92; *Bahamas Sisal Plantation* v *Griffin* (1897) 14 TLR 139; *Astor Properties Ltd* v *Tunbridge Wells Equitable Friendly Society* [1936] 1 All ER 531).

(b) The additional interest which the borrower may have to pay to procure the loan from an alternative source may be claimed if such a higher rate of interest is reasonably foreseeable at the time the contract is made (*The South African Territories Ltd* v *Wallington* [1898] AC 309 at 696-697).

(c) If the borrower is unable to raise the loan from alternative sources at all or as a result is unable to complete some transactions for which the money is required or becomes insolvent, the lender may be liable for all consequential losses reasonably within the contemplation of the parties, including loss of profit. Under this head, it has to be proved that the lender has express notice of the purpose of the loan (*Manchester and Oldham Bank* v *Cook* [1853] 49 LT 674 at 678, 679) and possibly also that the loan was agreed to be made for that purpose and for no other. In the context of building projects, the liability of a lender under this head could be substantial, depending on the market demand for the flats in the project. In particular, the lender may be liable for loss arising from forfeiture of the deposit paid by the developer to the Government and any penalty imposed by the Government for breach of the building covenant period resulting from any delay (which is occasioned by the default of the lender in making available the loan facility contracted for). In building project finance in Hong Kong, it will be difficult for the lender to deny express notice of the purpose of the loan. There are normally express provisions as to the use of funds. Information memoranda are usually required before the decision to lend is made.

5.3 The purpose of the loan

The loan agreement usually expressly provides for the use of the proceeds drawn under the purchase facility to be applied towards the purchase of the project land, and those drawn under the construction facility, towards the payment of construction costs and engineer's and architect's fees.

The agreement will also provide for close monitoring of the use of the proceeds of the loan by permitting drawdowns only against supporting evidence, such as the architect's certificates. Where the lender so desires, express power may also be conferred on him to make direct payment to the intended recipients of the funds on behalf of the borrower. However, such power is normally used as a reserve power.

If, for any reason, the specific purpose of the loan fails, the lender may sometimes have equitable remedies *in rem* for the recovery of the lender's money, which are superior to actions *in personam* on the loan since they may enable the lender to recover the money even where the borrower is insolvent (*Re Nanwa Gold Mines Ltd* [1955] 3 All ER 219). In applying for such a remedy *in rem*, it is sufficient to show that the money has been lent on condition that it should be applied for a specific purpose. It is not necessary for the lender to show that on the failure of that purpose, a resulting trust arises in his favour (*Quistclose Investments Ltd v Rolls Razor Ltd* [1970] AC 567).

Where the borrower is a corporate entity, the court has held that a loan for an ultra vires purpose will be void if the lender had knowledge of the intended purpose of the loan (*Introductions Ltd v National Provincial Bank Ltd* [1970] Ch 199). With the enactment in 1997 of

the principal debtor, although such rights must be subject to the equity arising out of the knowledge of the creditor of the relationship between the guarantor and the principal debtor. Thus, to say a person is a guarantor implies only that it has become bound as an additional party, that its promise is only a security for the principal debtor (the person enjoying the consideration given by the creditor under the principal contract) and that it is given with a right (express or implied) to be indemnified by the principal debtor.

The exact scope of liability of a guarantor depends on the terms of the guarantee itself. But, if a person contracts 'to guarantee' another person, prima facie, it undertakes not merely to perform what the principal debtor fails to do; it undertakes to see that the principal debtor will perform in accordance with the terms of the principal contract. Therefore, if the debtor fails to perform its obligations vis-à-vis the creditor, the creditor can recover damages from the guarantor even though the guarantee does not stipulate the payment of damages. In other words, a guarantor's obligation continues after the termination of a principal contract by repudiatory breach although such obligation is transmuted into an obligation to pay damages (just as the principal debtor may be liable) (*Moschi* v *Lep Air Services Ltd* [1973] AC 331; *Sunbird Plaza Pty Ltd* v *Maloney* (1988) 166 CLR 245 at 254-255).

A guarantee is to be distinguished from an indemnity. The essential distinction is that in a contract of guarantee, the guarantor assumes a secondary liability to be responsible for the default of the debtor who remains primarily liability, either alone or jointly with the principal debtor. This principle is easier to state than to illustrate. Thus, A is giving a guarantee if he says to B: 'Supply goods to C and, if he does not pay, I will.' But he will be giving an indemnity if he says to B; 'Supply goods to C and, if he does not pay, I will.' But he will be giving an indemnity if he says to B; 'Supply goods to C and I will see that you are paid.' It is always a question of construction whether a person is liable as a guarantor or an indemnifier.

The distinction is relevant to the question of liability of the guarantor if the transaction guaranteed is invalidated by the incapacity of the borrower, or on other ground such as illegality fraud or misrepresentation. The position appears to be that for a guarantee a guarantor cannot be liable if the principal debtor cannot be liable (*Gerrard* v *James* [1925] Ch 616; *Yeoman Credit Ltd* v *Latter* [1961] 2 All ER 294; *Heald* v *O'Connor* [1971] 2 All ER 1105; *Swan* v *Bank of Scotland* (1836) 10 Bligh (NS) 627; *Brown* v *Blaine* (1884) 1 TLR 158; *Temperance Loan Fund Ltd* V *Rose* [1932] 2 KB 522; *Barclays* v *Prospect Mortgages Ltd* [1974] 1 WLR 837; *Chan* v *Cresdon Pty Ltd* (1989) 168 CLR 242; *Associated Japanese Bank (International)* Ltd v *Credit du Nord SA* [1989] 1 WLR 255). But

there is no reason why the lender cannot be indemnified for a void transaction. This is because an indemnity, unlike a guarantee, is a primary autonomous undertaking which is not dependent for its content or enforceability on the terms or validity of the undertaking given by the debtor.

The normal incidents of a guarantee or an indemnity can be altered or modified by the contracting parties. Thus, it is not unusual for a party to a contract to be a principal debtor as against the creditor but a guarantor as against the debtor. Indeed, for many years such an arrangement has been entered into to avoid the technical legal rules arising from the accessory nature of a guarantee, whereby the guarantor becomes discharged in certain circumstances, such as incapacity of the debtor. Such qualifications to the incidents of the guarantee will take effect according to its own terms (*Duncan, Fox & Co* v *The North & South Wales Bank* (1880) 6 App Cas 1 at 11-12). Similarly, it is possible for a guarantee and an indemnity to be combined.

16.2 Functions of a guarantee in a project loan

Quite often, the project lender may require the sponsors to give guarantees for the project loan. Such guarantees serve a number of useful purposes.

(1) Piercing the corporate veil

Guarantees given by the sponsors enable the lender to pierce the corporate veil of the borrower. The sponsors are the true operators of the project. By employing the corporate vehicle of the borrower, they do not have liability and responsibility. Through the guarantee, the sponsors are now liable and responsible for the project in terms of the guarantees.

Generally speaking, the giving of guarantees demonstrates the confidence of the sponsors in their own judgment of the financial soundness of the project and in the operation and management of the borrower company.

(2) Monitoring the sponsors financially

The provisions requiring guarantors to submit periodic information as well as other monitoring covenants in guarantees enable the lender to have a continuous assessment of the financial position and operations of the true operators of the building project, and hence any difficulty which the project may encounter after its inception.

(3) Second source of repayment

Guarantees provide an important second source of repayment of the project loan other than the project assets. They enable the lender to have recourse against the sponsors who often have a long business history and ability to repay the borrower's loan.

16.3 Terms of a financial guarantee

Lenders are vulnerable to various technical rules which enable a guarantor to avoid liability. Protective clauses are often inserted to counter the effect of such legal rules. As noted in Chapter Fifteen, a guarantee, like any third party collateral will be construed strictly and subject to risks of being challenged on grounds such as unconscionability or undue influence.

(1) Recital

A recital is not a necessary part of a guarantee but is commonly inserted where the transaction and documentation may be complicated.

A recital may function as an aid to the interpretation of the terms of the guarantee as guarantees are construed with reference to the factual matrix of the transaction concerned at the time (*Hyundai Shipbuilding & Heavy Industries Co Ltd* v *Pournaras* [1978] 2 Lloyd's Rep 502 at 506; *Bank of India* v *Trans Continental Commodity Merchants Ltd* [1982] 1 Lloyd's Rep 506; *Australia & New Zealand Banking Group Ltd* v *Beneficial Finance Corp Ltd* (1983) 44 ALR 241.

A term, expressed in general terms, may be restricted in construction by the recital qualifying the operative part of the guarantee. Where the recital states, in unambiguous terms, that the guarantee is given by the sponsors to secure the project loan according to the proportion of their respective shareholdings in the project company (the borrower), it seems that each sponsor's liability under the guarantee must be limited to such proportion even though the guarantee is expressed to cover all indebtedness (cf *Australian Joint Stock Bank Ltd* v *Bailey* [1899] AC 396). The existence of other securities recited may also be construed as conditions precedent to the liability of the guarantor (cf. *Australian & New Zealand Banking Group Ltd* v *Beneficial Corp. Ltd* (1983) 44 ALR 241; see paragraph 16.3(3) below). In other words, a guarantor is claiming that his or her guarantee is given on theirs of the simultaneous provision of other securities by other persons.

However, where the words of the guarantee are clear, the court will give effect to their natural and ordinary meaning. The question in every case is whether it can be gleaned from the recital that the intention of the parties requires the terms of the guarantee to be qualified. (*Australian Joint Stock Bank Ltd* v *Bailey* [1899] AC 396 and *Amalgamated Investment & Property Co Ltd (In Liquidation)* v *Texas Commerce International Bank Ltd* [1981] 1 All ER 923 at 929, affirmed [1981] 3 All ER 577.)

(2) Consideration

As is the case with all contracts, a guarantee must be supported by consideration unless it is executed under seal. In the case of a building project, the consideration is the entering into the principal loan agreement and the making available of the facilities for the acquisition of the project land and for the construction of the building project.

It is important that the consideration must not be past. If the guarantee is for a fixed loan but executed only after the loan has already been made to the borrower, the consideration is past and the guarantee is bad in law (*Bank of Montreal* v *Sperling Hotel Co Ltd* (1973) 36 DLR (3d) 130).

Moreover, the consideration stated in the guarantee must be accurate. This is because as a matter of construction, the stated consideration is a condition precedent to the liability of the guarantor under the terms of guarantee. Until such conditions precedent are fulfilled, the guarantor is not bound (*Bacon* v *Chesney* (1816) 1 Stark 192; *Burton* v *Gray* (1873) LR 8 Ch App 932).

(3) Operative clause

A typical operative clause may provide that the guarantor unconditionally and irrevocably guarantees the due and prompt payment by the borrower of all principal and interest and other moneys payable under the principal loan agreement and shall upon demand by the lender cause forthwith to be paid the principal debt provided that the liability ultimately enforceable against the guarantor shall not exceed a stated limit. This clause calls for comment in several aspects.

(a) Unconditional guarantee

A guarantee expressed as 'unconditional' may indicate the agreement that the guarantors' liabilities are not subject to conditions precedent.

A project loan inevitably will be secured by some other guarantees, charge on shares, mortgage of the project site, a floating charge of the borrower's assets and other securities. The guarantee may be construed