High Court shocks financial sector

Commentary on the decision of the court in HCMA No. 654 of 2020 (arising from CS No. 43 of 2020) Ham Enterprises Ltd and others Vs. Diamond Trust Bank (U) Limited and Diamond Trust Bank (K) Limited.

Background

On 7th October 2020, the High Court of Uganda delivered a ruling that sent shock waves through the banking and financial services industry and one that is sure to elicit a reconsideration of external debt into Uganda. Members of the Loan Market Association and parties to, and advisors on, foreign (bank) financing transactions related to Uganda will be particularly interested in the implications of the decision and any developments in relation to it as it progresses through appeal stages.

The crux of the decision of the High Court is that a foreign bank may not provide credit facilities to Ugandan entities or persons in Uganda without obtaining the approval of Uganda's Central Bank or being regulated as a financial institution in Uganda. The court decision is anchored on three main positions, that is, i) providing credit to Ugandan entities by a foreign bank amounts to conducting financial institutions business, for which a license is required; ii) nominating a local bank to manage a lending transaction including collections on behalf of a foreign bank amounts to agent banking, for which the approval of the Central Bank must be obtained; and iii) a foreign bank that lends/intends to provide lending to persons in Uganda must establish a representative office in Uganda.

The facts

The facts of the case are in and as of themselves quite unremarkable. Indeed, even though similar facts have previously come up in Ugandan courts, not once before has a Ugandan court come to a conclusion such as the one under consideration.

The facts indicate that Ham Enterprises Ltd, Kiggs International (U) Ltd and Hamis Kiggundu obtained a facility from DTB (U) Limited, a Ugandan bank and another facility from DTB (K) Limited, a Kenyan bank. DTB (K) appointed DTB (U) as an agent to manage and collect payments on its behalf and remit the same to it. DTB (K) also took security offered by the borrowers.

It appears there was a default on the loans. The borrowers raised concerns with regard to monies allegedly deducted from their accounts illegally and filed a suit against the two banks to account for the alleged deductions and, presumably, to forestall enforcement action. A statement of defence was filed by the banks. In response, the borrowers filed an application to strike the banks' defence off court record on the ground that it was a perpetration of illegalities by the banks, that is, illegally conducting *financial institutions business* in Uganda or conducting business contrary to the Financial Institutions Act, 2004 as amended (the '**Act**').

The application was opposed by the banks on the grounds that no *financial institutions business* was conducted by the Kenyan bank and that there was no breach of the Act. In its ruling, the court agreed with the borrowers, and in nullifying the transactions and striking out

the defence, also allowed the borrowers to succeed on the prayers in the plaint, without having gone through a full-blown trial.

In the aftermath of the decision, the Uganda Bankers' Association, an umbrella organisation of Ugandan banks, issued a strong statement objecting to the decision of the court and vowed to join efforts to overturn it. The Central Bank, as the regulator against whom a direct order was made by the court; to ensure that the Act is complied with, issued a statement indicating that it did not have the mandate to regulate the activities which the court alluded to. The Government of Uganda, through the Ministry of Finance Planning and Economic Development, also issued a general statement reassuring its partners that it intends to honour its financial obligations under the myriad of agreements signed, where it is, invariably, a borrower.

The banks have since lodged an appeal against the decision and applied for it to be stayed or suspended until the appeal is considered by the Court of Appeal. When allowing the application for stay on 2nd November 2020, the Principal Judge of Uganda considered the effect of the decision on *other* banks and the industry, in particular, the declaration that syndicated loans are, in terms, illegal and that foreign banks may not provide credit to entities in Uganda without the approval of the Central Bank.

We have reviewed the decision and the law on which it is hinged and are of the opinion that the court manifestly erred on the application of the Act and the holding that the banks were engaged in illegalities.

Financial institutions business

The court held that the provision of credit outside Uganda to a Ugandan entity by a *foreign bank* amounted to conducting *financial institutions business*. This was an error.

- The conduct of *financial institutions business* is regulated by the Central Bank under the Act. This business is a preserve of Ugandan companies licensed as such. The Act has provisions relating to *foreign banks* but what they do within or outside of Uganda is not considered a *financial institutions business* within the meaning of the Act. In the context of this case, to provide *financial institutions business* one must be *'accepting deposits'* and '*lending or extending money held on deposit or any part of that money*'. In our view, such deposits should be taken from the public in Uganda and held in Uganda and the lending primarily undertaken in Uganda.

- DTB (K) is not involved in accepting deposits in Uganda and could not be taken to be lending money held on deposit to bring it within the purview of the law. The Act does not regulate DTB (K)'s business in Kenya nor concern itself with how DTB (K) generates and or utilizes its funds in Kenya. To conclude otherwise, would to be to confer upon the law, a Ugandan court and the Central Bank as regulator, extra territorial reach. In our considered opinion, this is not the intention and letter of the law.

- A *foreign bank* can take deposits (in its country of operation and in accordance with the laws of such country) from persons in Uganda. Similarly, it can extend credit outside Uganda to persons in Uganda.

Agent banking

The court held that in appointing DTB (U) as a collecting bank and to manage its loan portfolio with the borrowers, DTB (K) was conducting *agent banking* and therefore required Central Bank regulation and approval. This too was an error.

- *Agent banking* was introduced in Uganda in 2016 as part of the wider effort of financial inclusion and deepening; to enable local banks (financial institutions) to reach the unbanked population and bring services closer to people. It would appear that the court did not consider the policy approach behind the enactment. Neither did it differentiate *agent banking* within the meaning of the financial institutions law from an agent under loan based transactions or other typical agency functions that a bank may perform.

- *Agent banking* is not designed for agency roles performed by local or other banks such as collecting payments, holding collateral on behalf of lenders and handling communications between a borrower and lender(s) as would, for example, be the case in a typical LMA multilateral transaction. Indeed the provisions of the law relied on by the court clearly reference agents of financial institutions in Uganda, and as indicated above, DTB (K) cannot be taken to be a financial institution within the meaning the Act. As such, it could not have appointed, and indeed no *foreign bank* can appoint, an agent pursuant to the terms of the Act.

- It also follows that for one to be an agent, they must be providing *financial institution business* on behalf of the appointing *financial institution*. The mere collection of payments (not being deposits) and such other administrative tasks do not fall within the ambit of *financial institutions business*.

- The Financial Institutions Act does not stop DTB (K) or any *foreign bank* from appointing a local bank as an agent for purposes of collecting its proceeds under a facility or as a security or collateral agent. Equally, and without more, a local bank may act as an agent for a *foreign bank*.

- From a cross border perspective, it is now a well held market practice that the role of the agent (where incorporating LMA provisions, which this did not given its bilateral nature) is largely a mechanical and administrative role notwithstanding any general common law duties. Where the parties have express duties arising from detailed commercial agreements, the courts are minded to *mostly* narrowly look to these terms as being the total of the involvement of the agent. In this case the governing law was Kenyan law and the court considered provisions under the law in Kenya and there may be further jurisdictional issues to consider here on appeal. In the majority of cross border deals in Africa where English law is chosen as the governing law, it may be comforting to note that this narrow approach is taken and, further, that the indemnities and limitations included on behalf of the agent are effective. However, even on this basis the judgement may not allow for clean opinions on Ugandan transactions with an agent where Central Bank approval is not sought.

Foreign bank office

The court held that DTB (K) did not comply with the provisions of the Act that required it to open an office in Uganda as a *foreign bank* with the approval of the Central Bank. Again, this was an error.

- In the first place, the court interchangeably uses the phrases *foreign bank* with *financial institution* in reference to DTB (K). Within the provisions of the Act, one cannot be both. Whereas DTB (K) is a *foreign bank*, it is not a *financial institution*. This mix up led the court to find that, as a *financial institution*, DTB (K) was conducting business without regulatory approval.

- The provision of the law on *foreign banks* states that foreign banks may have *representative offices* in Uganda. There is no mandatory requirement for a *foreign bank* to have an office in Uganda. This is a commercial decision left to the *foreign bank* as to how it wishes to be projected in the country. When it chooses to have an office however, it must be approved by the Central Bank.

- The reasons why a *foreign bank* may wish to have a representative office are many and may include a need to market its products and to create a liaison office. In particular however, a *foreign bank*, whether through its representative office or otherwise, may not undertake deposit taking business in Uganda. Further, the business conducted by a foreign bank through the representative office is termed as 'activities' under the Act rather than *financial institutions business*.

- For context in this case, it was an agreed fact between the parties that the lending in question happened in Kenya. A *foreign bank* can extend credit facilities in Uganda and obtain security without the need for regulation by the Central Bank and more particularly, in the absence of a representative office.

Syndication

The decision also frowns upon the practice of syndication (without Central Bank approval) when the court says that; *'the matter shows syndicated financial institutions business by … aimed at dodging the seeking of a license from the relevant authority which actions are clearly illegal'.*

- This was not a syndicated facility. The two facilities were given separately with the only commonality being the group ownership of the lenders and of the borrowers.

- It is however a fact that many syndicated transactions in Uganda will be, and are shored up, by *foreign banks*. To that extent, and in light of the fact that the court has held that *foreign banks* must obtain approval before extending facilities to Ugandan businesses, this decision poses a challenge to existing, pipeline and future financing transactions.

- As stated however, we are of the opinion that the court erred in this regard. We have not come across a law that prohibits *foreign banks* from lending into the country; and syndicated facilities are lawful. Until the decision is set aside however, it remains a cause for concern.

Recovery under 'illegal' contracts

Consequent upon the court's finding that the banks illegally conducted *financial institutions business* in Uganda without the necessary regulatory authorisations, the court declared the credit facilities advanced by DTB (K) illegal, void and unenforceable. The court also found that the credit facilities between the parties had since been settled at law. The basis for the latter finding (especially given that the court didn't hear the evidence on the matter) remains unclear.

- Whereas it is correct to say that a contract may be void at law, there are provisions under the Contracts Act of 2010 where protection for recovery is available to a party. There also exists judicial precedent where actions have successfully been based on the principle of unjust enrichment and restitution. The decision of the court has no consideration of these positions of the law one way or the other.

- If the court had considered the provisions of the Contracts Act and the available jurisprudence, it would have been easier to understand the finding of the court that the facilities had *been settled at law*. Similarly, the decision would have been better understood if the court had assessed the law and shown the basis upon which borrowers were entitled to recover the monies claimed, notwithstanding that the transaction has been declared illegal, void and unenforceable.

Non-Bank lenders

The decision of the court focuses on *foreign banks* and makes no mention of facilities that are provided by non-bank lenders such as equity, venture capital and other investment funds, DFIs and finance companies.

- Such entities may extend credit to persons in Uganda, solely or in syndication with other lending institutions and appoint agents for purposes of administering facilities, without giving rise to the need for regulation under the financial institutions regime in Uganda.

- To that extent, the decision offers no immediate challenge or risk to such non-bank lending institutions. The decision however creates a very unnerving environment that would worry any credit provider as to what reasoning and application of the law, a Ugandan court may provide in future.

Conclusion

By and large, this case appears to be one where a borrower had fallen on hard times. It may be that the lenders needed to explain the transactions and account operation to the borrowers. Whatever the case, in the borrowers' moment of struggle to stay afloat, an argument was made to and accepted by the court, albeit, in our opinion, with less than the necessary degree of scrutiny.

- The premise of the decision of the court was, in our opinion, flawed. It does not address the policy considerations behind the legislation or explore what is or has been acceptable practice; it does not properly apply the provisions of the law to the facts

and is indifferent to the impact of the decision on the financial services sector and the economy at large.

- We are aware that this decision has been challenged. As indicated, its effect has also been stayed to allow the Court of Appeal to consider its correctness. There is a further layer of appeal to the Supreme Court by any party that may be dissatisfied with the Court of Appeal decision.

- Until it is completely set aside however, it is difficult to see what comfort credit providers, in particular foreign banks, can take from the argument that the court got it wrong on the day, save that the correct position will be stated by higher courts at the earliest. It is expected that this will happen given the provisions of the law, the bearing the decision may have on the economy, and the keen interest of significant market players shown.

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