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FOREIGN ILLEGALITY IN FRAUD PROCEEDS ARISING FROM UNDERGROUND CURRENCY EXCHANGE ARRANGEMENTS

THE CURRENT STATE OF THE LAW IN HONG KONG SAR

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SUMMARY

This note considers the current state of the law in Hong Kong with respect to foreign illegality and whether it can set aside defences of *bona fide* purchaser for value without notice or change of position, in the context of fraud schemes where the fraud proceeds in one way or another were transferred to the recipient by way of currency exchange arrangements.

The current prevalence and proliferation of social media and technology has opened up more and more avenues for fraudsters to use different methods to defraud their victims.

Assuming that the location of the funds can be identified, a fraud victim's usual civil recourse would be first to apply for an injunction to resist dissipation of the defrauded proceeds from the bank account, and then an Order 14 judgment on the statement of claim on the grounds that any defences of the defendant(s), if raised, being *bona fide* purchaser(s) for value without notice or there being a change of position are not applicable.

This article concerns the current state of the law regarding a particular factual scenario (involving underground foreign currency exchange arrangements) where the victim was defrauded into transferring amounts to fraudster account(s), which were then further transferred to second layer account recipients. These second layer account recipients have then sought to shield themselves from liability by claiming that such amounts were received as a result of underground foreign currency exchange arrangements, where the second layer recipient remits money to first layer fraudsters under this arrangement, and receives money in the requested currency in return. Therefore, second layer recipients would raise the defence against the claims of fraud victims to the effect that they were *bona fide* purchasers for value without notice, or that they have changed their positions and used this as a basis for resisting the victims' summary judgment applications.

ILLEGALITY OF FOREIGN CURRENCY EXCHANGE ARRANGEMENTS

Subject to specific factual findings and advice from PRC lawyers, currency exchange arrangements involving RMB are well-established to be illegal under PRC law, and this position is accepted in the Hong Kong courts as well. Such arrangements contravene the PRC Foreign Exchange Measures for Individuals (個人外匯管理辦法) ("Measures") and the PRC Administrative Regulations on Foreign Exchange (中華人民共和國外匯管理條例) ("Regulations"). The relevant provisions are as follows (please note that the English translations are not official):

- **Article 30 of the Measures**: 境內個人從事外匯買賣等交易，應當通過依法取得相應業務資格的境內金融機構辦理 (Individuals engaged in foreign exchange trading and other transactions within the territory of the People's Republic of China shall conduct their business through domestic financial institutions which have obtained corresponding business qualifications pursuant to law.)

- **Article 39 of the Measures**: 對違反本辦法規定的，由外匯局依據《中華人民共和國外匯管理條例》及其他相關規定予以處罰；構成犯罪的，依法移送司法機關追究刑事責任 (Where there is any violation of the provisions of these Measures, the foreign exchange authorities shall impose punishment upon the parties involved according to the Regulations of the People's Republic of China on Foreign Exchange Management or other relevant provisions; where such actions constitute a crime, the involved parties shall be investigated by judicial authorities for criminal liability.)

- **Article 45 of the Regulations**: 私自買賣外匯、變相買賣外匯、倒買倒賣外匯或者非法介紹買賣外匯數額較大的，由外匯管理機關給予警告，沒收違法所得，處違法金額30%以下的罰款；情節嚴重的，處違法金額30%以上等值以下的罰款；構成犯罪的，依法追究刑事責任 (If any one trades foreign exchange in private or in a disguised way, or for profiteering purpose or illegally recommends the purchase and sale of foreign exchange of which the amount is relatively large, the relevant foreign control organ shall issue a warning thereto, confiscate the illegal gains, and shall impose a fine of not more than 30% of the amount of foreign exchange involved in the illegal activities; in serious case, the relevant foreign exchange control organ shall impose a fine of more than 30% and not more than the equivalent of the amount of foreign exchange involved in the illegal activities; or it shall be subject to criminal liability if the act constitutes a criminal offence.)

The case of ***DBS Bank (Hong Kong) Ltd v Pan Jing*** [2020] HKCFI 268 has accepted evidence on PRC law to the effect that currency exchange arrangements that involve RMB that are conducted by unlicensed individuals are illegal and in breach of the relevant PRC laws (***Pan Jing*** at paragraph 40). ***Pan Jing*** has also been submitted as evidence (section 59 of the Evidence Ordinance (Cap. 8)) of the current position of PRC law by the Plaintiff in ***She Ching Yan v Cai Yunxiang and Others*** [2023] HKCFI 592 under section 59(2) of the Evidence Ordinance (Cap. 8) and Order 38 rule 7 of the Rules of the High Court (Cap. 4A), and such has been accepted by the court (***She Ching Yan*** at paragraphs 58 - 61).

To summarise, the current state of the law in this area is not set in stone, and there are some two broadly different legal approaches (discussed below) in the face of illegality in this manner.

The two different approaches are the “absolute” approach and the “proportionate” approach.

Absolute Approach

One line of authority suggests that in the face of any foreign illegality, the recipient of the funds that arose from such illegal arrangement:

- Would not be entitled to rely on the defence of change of position, because the recipient's actions that resulted in a change of position were illegal, making it not inequitable to require such recipient to make restitution of the fraud proceeds to the victim,
- Would not be entitled to rely on the defence of bona fide purchaser, since the funds arose from an illegal transaction and the recipient could not be considered to have “provided value” for the property.

The line of authority in Hong Kong in favour of the absolute approach follows ***Barros Mattos Junior v General Securities & Finance*** [2005] 1 WLR 247 in the UK.

The defendants in ***Barros*** received US dollars in exchange for Nigerian Naira, such exchange being in contravention of Nigerian foreign exchange legislation. The UK court held that the fact that the illegality was under Nigerian law, which is foreign to the English court, made no difference to the finding of illegality in the UK ("There is **no room for the exercise of any discretion** by the court in favour of one party or the other. If the recipient's actions of changing position are treated here as illegal, the court cannot take them in account" at paragraph 43, emphasis added). This is an absolute approach which gives no regard to the significance or nature of the illegality itself.

This absolute position was adopted in Hong Kong most recently in ***Americhip Inc. v Zhu Hongling*** [2021] HKCFI 2753. Albeit that the reasoning might be thought by some to be light, upon finding that the currency exchange was illegal under PRC law, the court accepted that "there is no defence to the plaintiff's claim for unjust enrichment against the defendant as a wrongdoer…on the basis of any change of position in good faith…The defendant cannot be accepted as a *bona fide* purchaser for value without notice" (at paragraph 90 of ***Americhip***). In finding this, the court followed the position under ***Barros*** above. It should be noted that in this case, both parties advanced PRC expert evidence on the state of the PRC law on currency exchange arrangements and whether it is illegal under PRC foreign exchange legislation, and the court had accepted the plaintiff's expert's findings to be more convincing.

Proportionate approach

The absolute approach to illegality by the court has been met with criticism, in that there are certain judgments which put forward the opinion that a defence of bona fide purchase for value / change of position may be allowed to succeed in the face of illegality where the criminality involved is relatively trivial, and that the law should be applied with a due sense of proportionality.

However as mentioned above, courts seem to differ as to how such proportionality should be applied.

This proportionate approach was further considered and applied in ***Lesnina H D.O.O. v Wave Shipping Trade Co Ltd*** [2022] 2 HKLRD 727, where the court considered that there were triable legal issues with respect to the plaintiff's arguments on illegality and thus refused to grant summary judgment against the recipients of the funds in question. The defrauded proceeds that the defendants (primarily the 8thand 10th) received arose from ordinary contracts for sale of goods, but the funds were remitted through an underground banking system (***She Ching Yan*** at paragraph 124). In response to the absolute approach, the court considered that it would be far too rigid and advocated for a more balanced approach. The court referred to the UK Supreme Court judgment of ***Patel v Mirza*** [2017] AC 467, which considered that in the realm of public policy, one could not judge whether allowing a claim which is in some way tainted by illegality would be contrary to public interest without considering the following:

- Underlying purpose of the prohibition which has been transgressed
- Conversely any other relevant public policies which may be rendered ineffective or less effective by denial of the claim
- The possibility of overkill unless the law is applied with a due sense of proportionality

FURTHER ANALYSIS OF THE TWO APPROACHES

The proportionate approach has been adapted in Hong Kong within the judgment of Lord Collins in the CFA decision of ***Ryder Industries Ltd v Chan Shui Woo*** [2015] 18 HKCFAR 544 at paragraph 39 which sets out principles relevant to determination of the legal effect of various types of foreign illegality:

1. If the contract is unenforceable under its proper law (whether chosen by the parties or otherwise), then it will not be enforced by the Hong Kong court ("**type 1 case**")
2. If the performance of the contract requires or necessarily involves conduct which is illegal under the laws of the place where it is required to be performed, then it will not be given effect regardless of its proper law ("**type 2 case**")
3. The contract will not be given effect regardless of its proper law "if the real object and intention of the parties [at the time of concluding the contract] necessitates them joining in an endeavour to

perform in a foreign and friendly country some act which is illegal by the law of such country notwithstanding the fact that there may be, in a certain event, alternative modes or places of performing which permit the contract to be performed legally" ("**type 3 case**")

4. If the actual performance of a contract involves violation of foreign laws "which was not required or initially intended", in such a case "a more flexible approach having regard to the seriousness of the foreign illegality is required to determined whether public policy and comity really require enforcement of the contract to be denied in such a case" ("**type 4 case**")

In ***She Ching Yan***, which involved another determination on summary disposal, the court made reference to conflict of laws principles, and considered that the court's approach to illegality should differ in accordance with the circumstances that gave rise to the alleged criminality. But ultimately in that case, the court considered that the immediate facts fell within the situation that required a rigid approach as in ***Barros*** to be taken, and thus granted summary judgment in favour of the Plaintiff.

The court in ***She Ching Yan*** analysed the distinguishing features of type 2, type 3 and type 4 cases as put forward in ***Ryder***:

- Type 2 cases cannot be performed in accordance with their terms without the commission of an act which is illegal in the foreign state, and are thus illegal "as to formation" (paragraph 123 of ***She Ching Yan***).
- Type 3 cases relate to intention and object of the parties, which taints the contract with illegality.
- Type 4 cases are those where "the performance does not necessarily involve or require the commission of an illegal act" (paragraph 124 of ***She Ching Yan***), and any violations of foreign laws which result from its performance were, as in the case of ***Ryder***, "not very serious", not conduct "which could be described as iniquitous" and would "not…have resulted in actual criminal or enforcement proceedings in the PRC" (paragraph 108 of ***She Ching Yan,*** paragraph 59 of ***Ryder***).

If the foreign illegality could not be avoided with regards to its performance, this would be considered a type 2 case where a rigid approach should be taken and the defendant's defence would be of no avail. To this extent, the law is clear. In ***She Ching Yan***, the defendant in question claimed that the defrauded proceeds that she received arose directly from a currency exchange arrangement for Hong Kong dollars which she entered into with a person she met via WeChat, who was not a licensed agent for currency exchange in the PRC. In exchange she transferred into an account directed by this person the equivalent amount in RMB. This is an arrangement well-established to be in contravention of PRC law. The court therefore concluded that the illegality arose at the stage when the money exchange contract is formed (i.e. "**type 2 case**") and the defences of bona fide purchaser and change of position do not apply to the defendant. In such a situation, the

court is of the view that there is nothing more to be explored in a trial (***She Ching Yan*** at paragraphs 122 - 123, 125).

But if the foreign illegality falls within a type 4 case and therefore that the court will need to make a judgment as to whether comity should require it to give effect to the contract or deny its enforcement by evaluating the seriousness of the illegality and the public policies which may underlie the impugned foreign law. A summary judgment would likely be viewed as inappropriate, as there are triable issues to be decided by the court (***She Ching Yan*** at paragraph 109). The question then is the determination of when a violation of foreign law would be trivial, insignificant or non-serious enough to fall within the ambit of a type 4 case.

This must necessarily be a determination that depends upon the facts of each individual case. But in terms of such foreign currency exchange arrangements, it is entirely credible, for secondary recipients to be in receipt of such fraud proceeds without any active or passive involvement in the underlying fraud perpetrated.

In ***Lesnina*** as discussed above, Deputy Judge Dawes SC accepted that, based on the evidence raised by the defendants, the defendants had not participated in the illegal underground banking system, and that in the court's view "…the mere fact that a defendant was in receipt of funds remitted through an underground banking system is without more [*sic*] insufficient to defeat a *bona fide* purchaser for value without notice defence or a change of position defence" (***Lesnina*** at paragraph 61).

In the case of ***Tokić, D.O.O. v Hong Kong Shui Fat Trading Ltd & Ors*** [2022] HKCFI 217, the court was of the view that if the foreign illegality was only to the extent that "…it breached some administrative rules and could attract a fine (as in ***Pan Jing***), the value he had given should be recognized. He should be entitled to rely on a defence of *bona fide* purchaser for value" (paragraph 48 in ***Tokić***). Yet it must also be recognized that in ***Tokić*** neither party had put forward any expert evidence on PRC law, which led the court to consider its findings to be only "preliminary", justifying its refusal of summary judgment.

CURRENT LEGAL POSITION IN HONG KONG

While it is clear that in terms of the foreign illegality bar, courts have seemed to accept that the absolute approach is indeed too rigid to deal with all cases of foreign illegality, and it is important to evaluate the seriousness of the illegality and important policies that may underlie the impugned foreign law before the court may deny the enforcement of a contract, subsequent court decisions on cases with a similar fact pattern appear reluctant to engage in further discussions on a type 2 or type 4 case determination, if they are satisfied that foreign illegality is clearly to be found "on formation". For example in a recent district court decision of ***Taihei Dengyo Kaisha Ltd v Zhao Yizhe*** [2024] HKDC 222, while recognizing that foreign illegality is a complicated and developing area of law, which in certain factual scenarios would justify further exploration in trial (paragraph 114 of

Taihei), in response to defendant counsel's suggestion that it is at least arguable that the immediate facts merit the treatment of a type 4 case, the court stated:

> "I do not think what Mr Zhu suggests is the correct approach…it seems to me that there is **no discretion or flexibility in identifying the type of the transaction concerned. Either the transaction falls within one of the types of it does not**, and I do not read *Lesnina, Tokić* and *Solyda* as authorities establishing otherwise (emphasis added)."

It would thus appear that despite acknowledging the rigidity of the absolute approach, courts appear reluctant to deviate from the spirit of it. Therefore, for now, victims of fraud may take comfort from the position that if they could put forward evidence to the effect that the defrauded sums received by the second layer recipient arose directly from underground money exchange services or other services which are well-established to be illegal under PRC law (i.e. formation of such arrangement is illegal under PRC law in itself) or relevant foreign laws with respect to foreign exchange, and such illegality is not merely administrative in nature, then the court would tend to adopt the more rigid approach in rebutting the recipients' defence of change of position or that they were bona fide purchasers for value without notice.

The approach towards the foreign illegality bar remains open to review, and with the continued prevalence and proliferation of internet and email fraud cases, this remains yet an evolving area that we can surely anticipate to be subject to further challenges by second layer recipients of fraud proceeds.

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