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Legal Update

Understanding the Trends: A Review of Insolvency Litigation in Hong Kong in 2023

Insolvency litigation witnessed intriguing developments across multiple aspects in Hong Kong in 2023, ranging from the court's updated Practice Direction on Bankruptcy and Winding-Up Proceedings to on-going debate surrounding the interplay between insolvency proceedings and arbitration clauses.

In this Legal Update, we examine major developments that unfolded.

The key takeaways are:

1. It is now clear that where there is an exclusive jurisdiction clause in the underlying agreement providing for a foreign jurisdiction, the court will generally hold parties to their bargain and stay or dismiss a creditor's bankruptcy/winding-up petition if the debt is disputed. But it's uncertain whether the same approach applies to underlying agreements with arbitration clauses.
2. The court confirmed that it would take a broad and macroscopic assessment when considering an appeal against a decision to admit or reject a proof of debt.
3. An updated Practice Direction adds new methods of service for a statutory demand in bankruptcy cases and clarifies various aspects of case management for insolvency proceedings.
4. The court has jurisdiction to grant an Order to compel a former director of a company in liquidation with centre of main interest in Hong Kong to ratify the replacement of himself as sole director of subsidiaries of the company by a new director.
5. *Keepwell* deeds are enforceable in Hong Kong, and the timing of breach is crucial.
6. For the first time, the court recognized cryptocurrency as property available for distribution by liquidators.
7. Hong Kong courts have consistently shown willingness to issue letters of request for cross-border recognition and assistance.

Interplay between Winding-up Proceedings and Jurisdiction and Arbitration Clauses

While a creditor commencing winding-up proceedings is enforcing a class remedy which affects all creditors, how far a creditor can do so where there is an exclusive jurisdiction clause providing for a foreign jurisdiction (EJC), or arbitration agreement in the underlying contract from which the debt arises, has been recently considered by the Hong Kong courts.

In its landmark decision in ***Guy Kwok-Hung Lam v Tor Asia Credit Master Fund LP*** [2023] HKCFA 9, the Court of Final Appeal importantly held that in the ordinary case of an EJC – absent countervailing factors such as the risk of insolvency affecting third parties, or a dispute that borders on the frivolous or abuse of process – the petitioner and debtor ought to be held to the terms of their contract (known as the "Guy Lam Approach").

In other words, where there is an EJC, the debtor would not be required to demonstrate a *bona fide* defence on substantial grounds in order to defeat a bankruptcy petition.

There is no doubt that the Guy Lam Approach applies to both bankruptcy and winding-up proceedings. However, an important question then is whether the Guy Lam Approach also applies to winding-up proceedings involving an underlying agreement with an arbitration clause.

In this regard, there have been inconsistent decisions in the Court of First Instance by Company Judges:-

1. On one hand, in ***Re Simplicity & Vogue Retailing (HK) Co., Ltd*** [2023] HKCFI 1443 and in ***Re NT Pharma International Co., Ltd*** [2023] HKCFI 1623, the Hon Madam Justice Linda Chan held that the Guy Lam Approach **does not apply** to arbitration clauses and made winding-up orders against both companies.
2. However, in ***Re Shandong Chenming Paper Holdings Limited*** [2023] HKCFI 2065, Harris J held that the Guy Lam Approach **does apply** to arbitration clauses. In a footnote of the judgment, the Hon Mr Justice Harris expressly referred to **Simplicity** and indicated his agreement to the submission by the company that Linda Chan J's ruling was wrong, as the Court of Final Appeal's view was clearly that the Guy Lam Approach should be taken to the application of an EJC and an arbitration clause.

Leave to appeal to the Court of Appeal was granted in ***Re Simplicity & Vogue*** and ***Re Shandong Chenming Paper Holdings Limited***. Guidance and clarification from the Higher Courts are much needed.

Challenging the Decision to Admit Or Reject Proof of Debt for Voting Purposes

In ***Re Pan Sutong*** **[2023] HKCFI 2620**, a creditor of the bankrupt (a company controlled by the bankrupt) lodged an appeal against the decision of the Official Receiver to accept proofs of debt lodged by another creditor for voting purpose at the first meeting of creditors.

The Hon Madam Justice Linda Chan held that general principles governing whether a proof should be admitted for voting in a winding-up apply equally to a proof in a bankruptcy; and principles governing appeal against a decision on admitting or rejecting a proof of debt for voting purpose include:

- The chairman of the creditors' meeting has power to admit or reject a proof. If there is a question or doubt, he shall admit the proof but mark it as objected.
- The decision at the first meeting is not final.
- On appeal, the court should undertake a broad, macroscopic assessment of the value at which the debt should be admitted.
- If the creditor makes out a clear *prima facie* case to support its contention that the amount claimed was due, it is for the party disputing the debt to put forward specific evidence or legal arguments as to why all or part of the amount claimed was not due.

Applying this approach, her Ladyship found that there was at least a *prima facie* case that the debt being challenged existed at commencement of the bankruptcy. The applicant creditor's

contention that it did not exist was rejected, being inconsistent with the bankrupt's own previous position as well as contemporaneous documents.

Updated Practice Direction for Bankruptcy and Winding-up Proceedings

On 30 June 2023, the Judiciary issued the updated **Practice Direction 3.1** which took effect on 17 July 2023.

The key updates include:

- For bankruptcy proceedings only, the most significant change is that for service of a statutory demand, a creditor can now use electronic means such as email, WhatsApp and WeChat – provided that the debtor has either agreed to use such electronic means to receive documents relating to the subject debt, or has communicated with the creditor by such means within 12 months immediately before the date of the statutory demand. Further, for a bankruptcy petition based on failure to comply with a statutory demand, except where the statutory demand is personally served on the debtor, the petitioner shall now file a new checklist (Appendix A) in addition to an affirmation of service. In general, the Master will grant leave to issue a petition or provide comments within 28 days.
- For winding-up proceedings only, the updated practice direction also clarifies how the petition shall be served in respect of various types of companies, namely Hong Kong companies, registered non-Hong Kong companies, non-Hong Kong companies with or without a place of business in Hong Kong, and unregistered companies with no place of business in Hong Kong.
- For both bankruptcy and winding-up proceedings (other than winding-up petitions on just and equitable grounds), it sets out various standard directions where the petition is contested and uncontested.

Order to Compel Former Director to Resign and Appoint a New Director

In ***Re China Properties Group Limited (in Liquidation)*** [2023] HKCFI 2346, Recorder William Wong SC addressed what he called "*an important legal issue concerning insolvency legal regime in Hong Kong*" when liquidators of a Cayman company in liquidation applied for urgent interim reliefs for an ex-director of the company to, *inter alia*, ratify by written resolutions the appointment of a sole director of four BVI subsidiaries of the company in place of himself.

The Cayman company was listed in Hong Kong and directly and wholly owned four BVI subsidiaries, which in turn hold various Hong Kong companies holding various Mainland subsidiaries. The Cayman company was ordered to be wound up by the Hong Kong court and the jurisdiction was established on the basis that the company's centre of main interest (COMI) is Hong Kong.

After the Cayman company was put into liquidation, no progress had been made for about three months because of the former principal officers' obstruction, including the ex-director's commencement of proceedings in the BVI against the liquidators.

While granting the Order sought by the liquidators, the Recorder held that Hong Kong courts have a duty to assist liquidators appointed by them to effectively and efficiently discharge their professional duties in the best interest of the general body of creditors.

In this regard, while Hong Kong is not the Cayman company's place of incorporation – and there may be questions of whether an Order by the Hong Kong court will be recognised in the BVI – the Recorder reasoned that it is more practicable to expect that BVI courts will not disturb orders

made by Hong Kong courts to assist the liquidators conduct liquidation effectively. Also, as the ex-director is a resident in Hong Kong, Hong Kong courts have *in personam* jurisdiction over him.

Keepwell Deeds are Enforceable and Timing of Breach Is Important

Due to Mainland China's foreign exchange control, a Chinese company intending to issue an offshore bond to foreign creditors may do so through offshore subsidiaries (as issuer or guarantor), which often do not have substantial assets to meet payment obligations on their own.

Accordingly, to provide some security to such foreign creditors, there is a practice of the Chinese parent company entering into a "keepwell" deed – by which the Chinese company undertakes, *inter alia*, to ensure that the offshore subsidiaries are solvent and will have sufficient liquidity to make payments under the offshore bond as they fall due.

Such keepwell deeds fall short of a guarantee (and therefore do not trigger registration requirements under relevant PRC law and regulations). But they are commonly seen to be a credit enhancement measure, and meant to be of some value to foreign creditors.

In ***Re Peking University Founder Group Company Limited*** [2023] HKCFI 1350, the Court for the first time held that such keepwell deeds are enforceable.

In this case, the Mainland parent companies entered into keepwell deeds, as well as equity interest purchase undertakings (EIPU), which included, *inter alia*, obligations for the parent companies to keep the offshore subsidiaries solvent and ensure they have sufficient liquidity to make timely payments.

Both the keepwell deeds and EIPUs are governed by English law with exclusive Hong Kong jurisdiction clauses. The financial position of the Mainland parent companies subsequently deteriorated, and they were ordered by the Beijing First Intermediate People's Court to commence reorganisation proceedings, with administrators appointed.

In ***Re Peking University Founder Group Company Limited***, four actions were commenced by the liquidators of the offshore subsidiaries (as offshore issuers and guarantors of the relevant offshore bonds) against the parent company for breach of the keepwell deeds and the EIPUs.

The Hon Mr Justice Harris held that:

1. Keepwell deeds and EIPUs are binding and enforceable.
2. As a defence, the Mainland parent companies are entitled to rely on one of the clauses in the keepwell deeds which provides that "*to the extent that the Company is required to obtain any Regulatory Approvals in order to comply with its obligations… the performance of such objection shall always be qualified by, and subject to, the Company having obtained such Regulatory Approvals. In this regard, the Company* ***undertakes to use its best efforts*** (emphasis added) *to obtain such Regulatory Approvals*".
3. If obligations under the keepwell deeds are triggered **before** the Mainland parent company is put into re-organisation, the parent company must prove it used its "best efforts" but still could not obtain the regulatory approvals.
4. On the other hand, if the obligations are triggered **after** the Mainland parent company is put into re-organisation, his Lordship accepted that it is practicably impossible to obtain the regulatory approval. Therefore the company is not in breach of the undertaking to use its "best efforts", even if it does not take steps to apply for the approval.

5. In all but one of the four actions, the parent companies' failure to perform its keepwell obligations occurred after the re-organisation, and therefore those companies did not breach their keepwell obligations.

Landmark Decision Confirming Cryptocurrency as a Type of "Property"

Cryptocurrencies have become a highly discussed topic in recent years, gaining popularity among the general public. As a result, there have been legal reforms at both the common law and legislation level in Hong Kong, to keep aligned with other major common law jurisdictions.

One notable development is that the Hong Kong court allowed proprietary injunctions to freeze cryptocurrencies, albeit without explicitly addressing the nature of cryptocurrencies.

Another significant milestone in cryptocurrency regulations is the landmark decision in the case of ***Re Gatecoin Limited (In Liquidation)*** [2023] HKCFI 914, handed down on 31 March 2023. This decision provides clarity on the legal treatment of cryptocurrencies in Hong Kong, particularly in the context of a winding-up scenario.

Gatecoin Limited, a Hong Kong-based cryptocurrency exchange platform, was wound up on 13 March 2019. Subsequently, the liquidators were able to secure over 50 types of cryptocurrencies with a total value of approximately HK$140 million. They sought directions from the court on, *inter alia*, the characterisation of the cryptocurrencies held by Gatecoin and the allocation of the cryptocurrencies to the customers. This raised the question of whether Gatecoin held the cryptocurrencies on trust for any of its customers.

The nature of cryptocurrencies is crucial in determining whether the liquidators had authority to realise and distribute the cryptocurrencies during the winding-up process. Section 197 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (CWUMPO) states that liquidators must take custody of all "*property*" upon a winding-up order.

In this regard, the Hon Madam Justice Linda Chan applied the classic definition of "*property*" established in the case of *National Provincial Bank v Ainsworth* [1965] 1 AC 1175, which defines property as something "definable, identifiable by third parties, capable of assumption by third parties, and possessing some degree of permanence or stability".

Based on this definition, the court concluded that cryptocurrencies are a form of property under Hong Kong law. On that basis, Her Ladyship further held that cryptocurrencies can be the subject matter of a trust, drawing an analogy to shares and stocks. On facts of the case, they were indeed held on trust in respect of a certain category of platform users.

This decision provides clarity on the legal foundation for cryptocurrency owners seeking various proprietary remedies and protective measures such as clawback provisions under CWUMPO. The decision also affirms the potential role of cryptocurrencies in diverse commercial and financing transactions, including their use as collaterals to provide security.

All in all, this momentous decision, which arrived in the wake of recent high-profile collapses of major cryptocurrency exchanges, brings reassurance to insolvency practitioners and creditors, as it demonstrates that cryptocurrency transactions can be readily integrated into the existing insolvency regime.

Mutual Recognition of Insolvency Proceedings

The pilot measure for mutual recognition and assistance of insolvency proceedings between the courts of three pilot areas in Mainland China and Hong Kong, known as the **Cooperation Mechanism**, was agreed in mid-2021.

Since then, liquidators in Hong Kong have had a more certain and structured route to seek, via Hong Kong courts, recognition and assistance from the designated Mainland courts in the three pilot areas, which include Shanghai, Shenzhen and Xiamen.

The Hong Kong court has been consistently willing to give effect to the Cooperation Mechanism, issuing letters of request to Mainland courts in the three pilot areas. The recent case of ***Re Husk's Green Technology Holding Co Ltd (in Liquidation)*** [2023] HKCFI 3054 (24 November 2023) is a further example of such willingness on the Hong Kong court's part.

(Please refer to our previous update titled '*Full-steam Ahead for Mainland-Hong Kong Cooperation Mechanism to Recognise and Assist Insolvency Proceedings in Pilot Areas and Beyond*' for further details.)

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