SLAUGHTER AND MAY/

CLIENT BRIEFING

JULY 2021

CROSS-BORDER INSOLVENCY IN HONG KONG

AN ORDER TO RECOGNISE AND ASSIST

"Since the court resumed hearings in May [2020] more than half the petitions I have heard have involved listed companies. Remarkably petitions to wind-up Hong Kong incorporated companies operating domestic businesses are currently a minority. In addition I have received weekly applications for recognition and assistance by soft-touch provisional liquidators of companies incorporated in one of the offshore jurisdictions and listed here intending to use the Z-Obee technique …"

--- Harris J (*Re China Huiyuan Juice Group Limited* [2020] HKCFI 2940 at [55]) (Date of Decision: 19 November 2020)

Cross-border insolvency is increasing active in Hong Kong. The quote above illustrates that a substantial portion of the winding up and insolvency proceedings case load in the Court of First Instance, Companies Court of Hong Kong stem from applications for recognition and provision of assistance to foreign liquidators.

An earlier client briefing available **here** considered applications to the Hong Kong courts for the compulsory winding up of a foreign company. This client briefing considers a different issue, being the recognition and assistance which Hong Kong courts may give to a winding up order issued by that foreign company's jurisdiction of incorporation.

1. General principles

1.1 Hong Kong is not a signatory to, and has not enacted, the UNCITRAL Model Law on Cross-Border Insolvency. The power to recognise and assist foreign insolvency proceedings derives from the common law.

1.2 In a typical fact pattern, the insolvent company is incorporated outside of Hong Kong (usually, in one of the popular offshore jurisdictions) but with assets situated in Hong Kong. A petition is granted for a winding up order in the company's overseas place of corporation and provisional liquidators are appointed. The provisional liquidators then apply to the Hong Kong court for 'recognition' of that overseas order such that it has extra-territorial application in Hong Kong by way of 'assistance' granted by the Hong Kong court.

1.3 The foundation of 'recognition and assistance' is derived from the corporate insolvency legal doctrine of "modified universalism". Under this legal concept, courts in the local jurisdiction should co-operate with the court in the jurisdiction where the principal liquidation takes place to ensure that all of the company's assets are distributed to its creditors under a single system of distribution.[1] This is to ensure that various creditor claims may be dealt with fairly and in accordance with a common set of rules which applies equally to all of them. The purpose of applying a common set of rules is to avoid a legal 'free for all' which descends into a legal foot race to present claims in the courts of various jurisdictions and grab the insolvent company's assets on a 'first come first served' basis.

2. The Mainland's Pilot Measure: Chartering new territory in Hong Kong?

2.1 On 14 May 2021, the Hong Kong Department of Justice and the PRC Supreme People's Court signed the "*Record of Meeting of the Supreme People's Court and the Government of the Hong Kong Special Administrative Region on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the Mainland and of the Hong Kong Special Administrative Region*" (**Record of Meeting**) on providing legal assistance in corporate insolvency and debt restructuring. The Record of Meeting marks a new chapter for creditors commencing insolvency proceedings in Hong Kong and having them recognised by and receiving assistance from Mainland courts in the pilot area. This is discussed in our earlier client briefing referred to above.

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[1] *Li Yiqing v Lamtex Holdings Limited* [2021] HKCFI 622 at [8].

2.2 However, from a Hong Kong legal perspective, no legislative amendment or new legislation was required in order to give effect to the Record of Meeting. This was because the Hong Kong common law framework already provided the necessary mechanics for granting recognition and assistance to Mainland proceedings (as discussed below).

3. Requirements for recognition

3.1 A Hong Kong court will recognise foreign insolvency proceedings that comply with the following criteria[2]:

(a) the foreign insolvency proceedings are collective insolvency proceedings; and

(b) the foreign insolvency proceedings are opened in the company's country of incorporation.

3.2 However, the Hong Kong courts' powers and jurisdiction are limited in situations when there is no equivalent under Hong Kong law to the assistance being sought.

3.3 Therefore, in the case of *Joint Administrators of African Minerals Ltd v Madison Pacific Trust Ltd*, the Hong Kong court refused to recognise an English administration proceeding on the ground that since "Hong Kong does not currently have any equivalent to administration and no statutory provision which provides for a moratorium on the enforcement of secured debt" it would be an "impermissible extension" of the court's power to give effect to the moratorium.[3]

3.4 However, when making this determination, the courts will look to the substance of the foreign proceeding and function of the officeholder. In the subsequent case of *Re CEFC Shanghai International Group Ltd (Mainland liquidation)*,[4] Mainland PRC administrators sought and were granted recognition and assistance by Justice Harris[5], who found that Mainland PRC administrators performed a similar role to that of Hong Kong liquidators.

4. Assistance to be granted

4.1 Given the proliferation of 'recognition and assistance' cases in recent years, the Hong Kong Companies Court has established an informal procedure and draft forms of order for recognition and assistance.

4.2 It is important that these procedures and forms be followed. This was a point highlighted in the recent *Re Agritrade Resources Ltd* decision[6] where the Hong Kong solicitors acting for the joint provisional liquidators submitted an application which did not comply with the established procedure and the form of order sought was materially different to the standard form. Justice Harris instructed his clerk to write to the solicitors to inform them that he was prepared to grant an order in the basic standard form. In his judgment, his Lordship remarked that: (i) it was important that the procedures and standard orders that have been developed are used, (ii) insofar as possible, the letters of request issued by the foreign court should be drafted to be consistent with the Hong Kong procedure and order, and (iii) his Lordship would recommend that the *Agritrade* decision be shown to judges in offshore jurisdictions in order so that they would understand the Hong Kong court's approach. While Justice Harris accepted that there will be cases in which the form of order may need to be amended, any change should only be arrived at after careful consideration.

4.3 The standard form of order includes the following powers for the overseas liquidator operating in Hong Kong:

(a) to develop and propose a restructuring of the insolvent company's (**Company's**) indebtedness in a manner designed to allow the Company to continue as a going concern, with a view to making a compromise or

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[2] *Re Kaoru Takamatsu* [2019] HKCFI 802 at [5].

[3] [2015] HKEC 641 at [12].

[4] [2020] 1 HKLRD 676. This was subsequently followed by *Re Liquidator of Shenzhen Everich Supply Chain Co Ltd* [2020] HKCFI 965, which was the second decision by the Hong Kong Companies Court to grant recognition and assistance to a Mainland PRC administrator.

[5] Currently, the Hon. Mr. Justice Jonathan Harris is the judge in charge of the Companies List in Hong Kong.

[6] [2020] 4 HKLRD 616.

arrangement with the Company's creditors, including (without limitation) a compromise or arrangement by way of a scheme of arrangement;

(b) to monitor, oversee and supervise the board of directors of the Company (**Board**) in its management of the Company with a view to developing and proposing any compromise or arrangement with the Company's creditors, and any corporate and/or capital reorganization of the Company and its subsidiaries (including but not limited to any share subscription and placement of shares in the Company and its subsidiaries);

(c) without prejudice to the generality of the foregoing, for the purpose of any proposal to be presented to The Stock Exchange of Hong Kong Limited (**SEHK**) for the resumption of trading of the Company's shares and maintenance of the Company's listing on the Main Board of SEHK, and to satisfy any resumption conditions:

(i) to investigate matters and report to the regulatory authorities where appropriate;

(ii) to liaise with the Company's auditors in relation to the provision of audited financial statements; and

(iii) to undertake a review of internal control systems and/or review the internal control report and monitor the progress of the special investigation committee of the Company;

(d) to seek out investors and financiers for the purpose of investing in and/or providing finance to the Company;

(e) to terminate, complete or perfect any agreement or transaction relating to the business of the Company, including, without prejudice to the generality of this power, to novate or assign any such agreements or transactions, so far as may be necessary for the purpose of managing the affairs of the Company, protecting the assets of the Company and restructuring the Company's assets and affairs to enable the resumption of trading of the Company's shares and maintenance of the Company's listing on the Main Board of SEHK;

(f) to oversee the existing Board (and attend any Board meetings) so as to effect a maximisation of returns to the stakeholders of the Company;

(g) to deal with all questions in any way relating to or affecting the assets or the restructuring of the Company;

(h) to do all such things as may be necessary or expedient for the protection or recovery of the Company's property and assets at law or in equity within the jurisdiction of the Hong Kong Companies Court as the liquidators may consider to be appropriate;

(i) with the consent of the Company, to supervise the operation and/or opening and/or closing of any bank accounts in the name of and on behalf of the Company;

(j) to operate and open any bank accounts on behalf of the Company for the purpose of paying costs and expenses of the provisional liquidation of the Company;

(k) to draw, accept, make and indorse any bill of exchange or promissory note or borrow funds for the purpose of the day to day expenses of the provisional liquidation, in the name and on behalf of the Company, with the same effect with respect of the Company's liability as if the bill or note had been drawn, accepted, made or indorsed or the loan had been entered into by or on behalf of the Company in the course of its business;

(l) to communicate with and carry out any necessary filings with regulatory bodies as appropriate, including, without limitation, the SEHK and the Hong Kong Securities and Futures Commission in the name and on behalf of the Company;

(m) to make payments to creditors which may have the effect of preferring such creditors, in order to minimise the interruption to the day to day activities of the Company;

(n) to discharge debts incurred by the Company after the commencement of the provisional liquidation of the Company as expenses or disbursements properly incurred in the provisional liquidation;

(o) to engage staff to assist them in the performance of their duties for the purpose of the provisional liquidation and to remunerate them out of the assets of the Company as an expense of the provisional liquidation;

(p) to appoint agents, attorneys and professional advisors as the liquidators may consider necessary to advise and assist them in the performance of their duties and to remunerate them for their reasonable fees and expenses out of the assets of the Company as any expense of the provisional liquidation;

(q) to authorise the Board to exercise such of the above powers relating to the Company on such terms as the liquidators consider fit; and

(r) to do all other things incidental to the exercise of the powers set out herein.

4.4 Furthermore, the standard order contains a provision that, for so long as the Company remains in provisional liquidation in its place of incorporation, no action or proceeding shall be proceeded with or commenced against the Company or its assets or affairs or its property within Hong Kong except with leave of the Hong Kong court and subject to such terms as the court may impose. This would ensure that proceedings would not take place in Hong Kong without the relevant parties being made aware of the foreign insolvency proceedings. Where appropriate, the Hong Kong courts can also order a stay of the Hong Kong proceedings to assist the foreign liquidation.[7]

5. Closer scrutiny of 'soft touch provisional liquidation'

5.1 Hong Kong's recognition of 'soft touch provisional liquidation' has seen notable changes in a relatively short space of time. These recent developments are considered below.

(a) Origins

(i) The 2006 Hong Kong Court of Appeal's decision in *Re Legend International Resorts Ltd*[8] held that Hong Kong provisional liquidators should not be appointed for the sole purpose of a corporate rescue. For example, under Hong Kong domestic insolvency law, a Hong Kong provisional liquidation will not be granted if the sole purpose is to effect a scheme of arrangement. Since a scheme of arrangement by itself does not provide an avenue for a legal stay on proceedings, which would allow creditors to continue to enforce their rights and start picking out assets from the company's asset pool in the interim, many companies contemplating a scheme of arrangement may wish to go into provisional liquidation as a complementary process to their scheme plans.

(ii) While there is a limited exception to the *Re Legend* decision, which was applied in *Re China Solar Energy Holdings Ltd*,[9] overseas companies have recently found a practical workaround. This involves an overseas court appointing a liquidator for (a) the sole purpose of effecting a restructuring or (b) (in the alternative) effecting a soft-touch provisional liquidation.

(iii) The essence of a "soft touch provisional liquidation" is that a company remains under the day to day control of the directors, but is protected against actions by individual creditors. This is a process which is available in some offshore jurisdictions, such as the British Virgin Islands, Cayman Islands, and Bermuda. However, is important to note that no such mechanism exists in Hong Kong domestic insolvency law. In fact, this is expressly ruled out in Hong Kong by virtue of the *Re Legend* decision.

(iv) Notwithstanding this, in a series of cases starting from the Hong Kong Court of First Instance's decision in *Re Z-Obee Holdings Ltd*[10] (involving overseas liquidators appointed for the sole purpose of effecting a restructuring) and then *Re Moody Technology Holdings Ltd*[11] (involving overseas liquidators appointed to effect a soft-touch provisional liquidation), the Hong Kong courts have placed emphasis on the

[7] *Re FDG Electric Vehicles Ltd* [2020] 5 HKLRD 701 at [7] and [9].

[8] [2006] 2 HKLRD 192.

[9] [2017] 2 HKLRD 1074.

[10] [2018] 2 HKLRD 338.

[11] [2020] HKCFI 416.

importance of the rationale underpinning universalism and have approved the proposition that "recognition may be given even though there does not exist under local insolvency law procedure equivalent to the foreign insolvency proceeding"[12].

(v) As a result of the *Z-Obee* and *Re Moody Technology* decisions, applications for recognition of overseas liquidators appointed (i) for the sole purpose of effecting a restructuring or (ii) effecting a soft-touch provisional liquidation, have proliferated. This chimes with Justice Harris' observations in *China Huiyuan Juice* that he was receiving weekly applications for recognition and assistance by overseas soft-touch provisional liquidators intending to use the *Z-Obee* technique.

(b) The Z-Obee technique scrutinised

(i) Until recently, the fact pattern or the applications for the recognition and assistance of overseas soft-touch provisional liquidators did not involve simultaneous winding up petitions that had commenced in Hong Kong.

(ii) This changed starting with the facts of *Li Yiqing v. Lamtex Holdings Limited*[13] (*Re Lamtex*) and *Re Ping An Securities Group (Holdings) Limited*,[14] which were heard before Justice Harris in the same week. Both cases involved insolvent Bermuda incorporated companies listed on the SEHK which had their business and operations in Mainland China and/or Hong Kong such that their centre of main interest (COMI) should be in Hong Kong or Mainland China and not Bermuda. On defaulting on their debt obligations, the creditors of these companies made applications petitioning to wind them up in Hong Kong, which was followed by these companies applying to enter into soft-touch provisional liquidation in Bermuda. The Bermudan court appointed provisional liquidators then applied to the Hong Kong court to adjourn the creditors' winding up applications. Justice Harris declined to adjourn the winding up proceedings in *Re Lamtex* but granted a two month adjournment in *Re Ping An Securities*. The key distinction was that when the soft-touch provisional liquidators were appointed in *Re Lamtex* (and indeed up to the date of hearing), there was no credible plan to restructure the insolvent company's debts. Therefore, in *Re Lamtex* it looked like that the Bermudan soft-touch provisional liquidation was an attempt to engineer a *de facto* moratorium prior to having a credible solution to resolving the company's financial issues, which was considered "a questionable use of soft-touch provisional liquidation" and his Lordship noted that Hong Kong courts will "view with care similar applications for recognition in the future".[15] Whereas in *Re Ping An Securities*, the company and the provisional liquidators had a credible restructuring plan, the success of which would be known within the two month adjournment being sought.

(iii) While *Re Lamtex* and *Re Ping An Securities* highlighted the Hong Kong courts closer scrutiny of overseas soft-touch provisional liquidations, a direct confrontation between recognition and assistance and a Hong Kong winding up petition only came to a head in the recent decision of *Re China Bozza Development Holdings Limited*.[16] In *Re China Bozza*, Justice Harris expressed concern that the *Z-Obee* technique was "being abused to obtain a *de facto* moratorium of enforcement action by creditors in Hong Kong".[17] His Lordship reiterated that, when it appears likely that a company is insolvent, then the company's directors' had a paramount duty to consider the interests of the company's creditors.[18] This 'creditors' interests duty' is grounded in the principle that, during a liquidation, creditors will be entitled to displace the power of shareholders and directors to deal with the company's assets, such that directors owe a duty to consider the interests of these creditors rather than just those of the company and

[12] *Ibid.* at [29] to [37].

[13] [2021] HKCFI 622.

[14] [2021] HKCFI 651.

[15] *Re Lamtex* [2021] HKCFI 622 at [42].

[16] [2021] HKCFI 1235.

[17] *Ibid.* at [4].

[18] *Ibid.* at [12] to [14].

shareholders.[19] A soft-touch provisional liquidation initiated with no apparent consideration given to the interests of creditors but rather as a way to avoid liquidation and retain shareholder value (as was the case in *Re China Bozza*, where Justice Harris drew a compelling inference from the evidence that creditors were viewed by the company and liquidators as a group to be bought off and not a group whose financial interests took priority) constituted a material deviation from how it was originally used in Hong Kong.[20] As a result, while granting recognition to the provisional liquidators in *Re China Bozza*, the Hong Kong court refused to provide active assistance by way of a standard order and confirmed that the mere fact overseas provisional liquidators had been appointed does not mean the Hong Kong courts will automatically adjourn the winding up petition.[21] Instead, the Hong Kong court only granted an order that the overseas provisional liquidators had liberty to apply for further orders provided that those orders could be justified.

(iv) These developments demonstrate the Hong Kong court's increasing scepticism towards overseas soft-touch provisional liquidation if the facts show its purpose is potentially to frustrate creditor interests.[22] Overseas companies and insolvency practitioners should be alert to the need to substantiate their recognition and assistance applications with cogent evidence that the proposed restructuring through soft-touch provisional liquidation aligns with and protects creditors' interests. As Justice Harris alluded to in *Re Lamtex* and subsequently reaffirmed in *Re China Bozza*, where there is both an application for recognition and assistance and a simultaneous Hong Kong winding up petition, the company and its provisional liquidators will need to demonstrate that their restructuring proposal is in the best interests of the creditors as a whole. One way of proving this is by adducing evidence that sufficient support exists amongst the creditors for their proposal (for example, having the necessary statutory majority support for a proposed scheme of arrangement). Only upon satisfaction of this will the Hong Kong courts exercise its discretion to adjourn the Hong Kong winding up petition.

(v) The importance to which the Hong Kong Companies Court treats these cases can be seen from Justice Harris' subsequent requirement that, going forward, all applications by SEHK listed companies for extensions of time to file evidence in opposition to a winding up petition or to adjourn the progress of winding up proceedings, even agreed adjournments, should be made before him (in his capacity as the Companies judge) or another judge as he directs.[23]

6. Conclusion

The Hong Kong common law framework has shown remarkable adaptability and innovation in the continued absence of new corporate rescue legislation. The developments in the law of recognition and assistance, guided by the principles of 'modified universalism', have managed to facilitate and develop alongside modern commercial practice and realities. This includes recognising and granting assistance to soft-touch provisional liquidations or liquidators appointed for the sole purpose of effecting a corporate restructuring, even though this is not available under Hong Kong domestic insolvency law. However, being adaptable does not mean being unprincipled. The Hong Kong courts will continue to uphold certain fundamental principles underpinning insolvency law, including the protection of creditor interests. Any perceived attempts to 'game the system' by engineering a *de facto* moratorium without consideration of the interests of creditors, as some overseas soft-touch provisional liquidations

[19] *Cyberworks Audio Video Technology Limited v Remedy Asia Ltd and others* [2020] HKCFI 398 at [66]. Cited with approval in *Re China Bozza* [2021] HKCFI 1235 at [14].

[20] *Re China Bozza* [2021] HKCFI 1235 at [22].

[21] *Ibid.* at [23] to [24].

[22] In *Re the Joint and Several Provisional Liquidators of Victory City International Holdings Limited* [2021] HKCFI 1370 (handed down after the *Re China Bozza* decision) Justice Harris deliberately commented on the potential misuse of overseas soft-touch provisional liquidation, before confirming that, going forward, he will "approach any applications for recognition and assistance which exhibit the characteristics I have described with the greatest circumspection" (at [23]).

[23] *Yao Weitang v. China Creative Global Holdings Limited* [2021] HKCFI 1565 (Date of Decision: 24 May 2021) at [7]. In explaining his rationale, his Lordship cited the principles in *Re China Bozza* in relation to the duties owed by directors of insolvent companies to unsecured creditors and his remark that the present case once again demonstrated that such duties were not being observed (at [9]).

have shown to be, will undoubtedly attract the Hong Kong court's scrutiny and scepticism. As seen in the court order granted in *Re China Bozza*, while Hong Kong courts will recognise the overseas provisional liquidator, Hong Kong judges can also exercise their discretion to refuse to adjourn the Hong Kong winding up proceeding or to refuse to provide active assistance. Companies and insolvency practitioners should, in light of the Hong Kong courts' change in approach described in this client briefing, be prepared to present evidence of substantive restructuring plans which demonstrably take into account the best interests (and ideally have the support) of creditors.

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