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CROSS-BORDER INSOLVENCY – WHAT YOU SHOULD KNOW AS A CREDITOR

With the global economic downturn, businesses may begin to show signs of insolvency. Indeed, we have seen an increasing number of applications for compulsory winding-up processed by Hong Kong courts.

If you are a creditor, you will naturally be concerned with making the right move when your debtor defaults in repaying the loan. Situations can be tricky if the debtor is an offshore company. As demonstrated in several recent cases regarding companies listed on the Stock Exchange of Hong Kong but incorporated in other jurisdictions and with assets and key businesses in mainland China, creditors will have to ponder a number of important issues when dealing with companies with similar tiered structures. This client briefing discusses these issues and considerations.

Winding up a company

If your debtor has defaulted in making payment, you will start to contemplate your options, one of which might be to wind up the company. However, there are issues you should weigh up before embarking on such course of action.

Winding up in Hong Kong

Is the debt disputed on substantial grounds?

You would rely on the debtor's inability to pay debts[1] to wind up the debtor company. This is usually established by the fact that the debtor has failed to settle the debt within three weeks after it had been served with a statutory demand.

Before issuing a winding-up petition, you should, first and foremost, seek legal advice as to whether the debtor will be able to raise a substantive defence. Creditors normally enter into correspondence with debtors before issuing a winding-up petition, through which creditors can draw out any arguments that the debtors may have in respect of the debt. If the debtor advances any credible arguments, you should think twice before commencing or even threatening to commence winding-up proceedings. Winding-up petition should not be used as a tool to exert pressure on the debtor to pay, especially if there is no genuine concern as to the company's solvency. Otherwise, the debtor may apply for an injunction to bar you from issuing a winding-up petition on the ground of abuse of process. You may be ordered to pay the debtor's costs on an indemnity basis[2].

The three 'core requirements' associated with the winding-up of foreign companies

You should also assess whether there are good reasons for Hong Kong court to exercise its jurisdiction to wind up the debtor company, while bearing in mind that the place of incorporation is generally deemed to be the most appropriate forum to wind up a company by the courts. In this regard, there are three 'core requirements' to satisfy:

(1) The foreign company must have a sufficient connection with Hong Kong;

(2) There must be a reasonable possibility that the winding-up order would benefit those applying for it; and

(3) The court must be able to exercise jurisdiction over one or more persons in the distribution of the company's assets.

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[1] Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32 of the laws of Hong Kong) section 327.

[2] *Hung Yip (HK) Engineering Company Limited v Kinli Civil Engineering Limited* [2021] HKCFI 153 at 16.

It should be relatively straightforward to satisfy the first and third core requirements if the company is listed or has substantial assets and businesses in Hong Kong and there is more than one creditor who is subject to the jurisdiction of Hong Kong court[3].

As for the second core requirement, the petitioner has to establish that there is a real benefit in granting the winding-up order.

The case *China Huiyuan*[4] demonstrates the complication with meeting the second core requirement in the case of an offshore company. China Huiyuan, which was incorporated in the Cayman Islands and listed in Hong Kong, had its core businesses and assets in the Mainland through intermediate holding companies incorporated in the BVI and operating subsidiaries in the Mainland. A creditor attempted to wind up this listed company in Hong Kong. As it appeared that the laws of the Mainland[5], the Cayman Islands, and the BVI did not recognise the appointment of liquidators by the Hong Kong court where Hong Kong was not the place of incorporation, even if the Hong Kong court were to make a winding-up order, the Hong Kong-appointed liquidators would not be able to take control of the subsidiaries and ultimately reach the assets in the Mainland. The second core requirement was therefore not met.

The creditor in *China Huiyuan* also sought to argue that the listed status of China Huiyuan constituted a real benefit. In rejecting this argument, Harris J observed that the listed status was unlikely to have any residual value once the company was wound up. His Lordship reminded future petitioners that if they wish to rely on a listed status to meet the second core requirement, they would have to adduce evidence to establish a real prospect that the realised listing of the debtor would produce a meaningful financial return to creditors[6].

As shown above, if your debtor does not have strong connections with Hong Kong, you should seek advice early on in choosing the venue to issue a winding-up petition, bearing in mind that the satisfaction of the three 'core requirements' is not a matter of course.

What to do if the company seeks adjournment of the winding-up

Unlike Hong Kong[7], many common law jurisdictions allow soft-touch provisional liquidation. 'Soft-touch' provisional liquidators (**PLs**) are appointed to facilitate corporate restructuring while the board maintains the day-to-day management of the company. The debtor, if incorporated in one of these jurisdictions, may appoint 'soft-touch' PLs in its place of incorporation and seek to adjourn the insolvency proceedings in Hong Kong.

The court, as illustrated in *Lamtex*[8], would approach the question of whether to adjourn winding-up proceedings in Hong Kong in favour of restructuring as follows:

- Generally, the place of incorporation should be the primary insolvency jurisdiction.
- However, if the company's centre of main interest (**COMI**) is elsewhere, the court would look at:
  - (a) the extent to which giving primacy to the place of incorporation is artificial by taking into account the strength of connection of the company with its COMI versus the place of incorporation;
  - (b) whether the group structure requires the place of incorporation to be the primary jurisdiction to effectively liquidate or restructure the group. The appointment of liquidators in the company's COMI may not bring about

[3] *Re China Huiyuan Juice Group Ltd* [2020] HKCFI 2940 at 25.

[4] *Ibid.*

[5] The legal position with respect to Mainland laws is changed due to the recently entered agreement between Hong Kong and the Mainland. Please see the section titled 'Mainland-Hong Kong arrangement on mutual recognition and assistance of insolvency proceedings' below.

[6] *Ibid* at 56.

[7] *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192, *cf*. *Re China Solar Energy Holdings* [2018] HKCFI 555.

[8] *Li Yiqing v Lamtex Holdings Ltd* [2021] HKCFI 622.

an effective liquidation of the company if the company has assets in jurisdictions which do not recognise liquidators appointed by the court of a place other than the place of incorporation;

(c) the views of creditors; and

(d) feasibility of the restructuring plan.

As in *Lamtex*, the court will not hesitate to wind up the debtor company if Hong Kong is the COMI, the creditors support the winding-up, and the restructuring proposal lacks specifics and is merely an attempt to derail the liquidation in Hong Kong. Further, even if the court initially adjourned the insolvency proceedings upon satisfaction of a viable restructuring plan as in *Ping An*[9], a winding-up order against the debtor may still be made in the end if the progress of the restructuring is unsatisfactory.

Winding up in the place of incorporation and seeking recognition and assistance in Hong Kong

If you anticipate difficulties with satisfying one or more of the three 'core requirements' discussed above, a safer course could be to wind up in the debtor company's place of incorporation. Liquidators appointed there may then seek recognition and assistance of foreign insolvency proceedings from Hong Kong courts to avail themselves of the powers under Hong Kong law, which include the power to take possession and control of the company's assets and to investigate its affairs[10].

Corporate restructuring and rescue

Even if you have every right to wind up the debtor, you may still wish to explore, with the debtor, the possibility of a corporate restructuring or rescue over simple liquidation. This is especially when the debtor has a profit-making business or a business with great potential.

Scheme of arrangement

There is at present no dedicated statutory corporate rescue mechanism in Hong Kong. Currently, the only way to effect a binding debt restructuring in Hong Kong is by way of a scheme of arrangement[11]. A binding compromise on a company's debts enables the debtor company to resume operation as a going concern. If successful, a scheme may yield better returns to unsecured creditors than immediate liquidation of the debtor. A foreign company with sufficient Hong Kong connections may also enter into such a scheme.

The company would first formulate a proposal seeking to compromise the company's debts. It should then seek the court's sanction to convene meetings of creditors and members for approval of the scheme. The company needs to secure approval of at least 50% in number representing at least 75% in value or voting rights of each class of the creditors or members present and voting. Even if the proposal is approved by the creditors and members, it should eventually be sanctioned by the court.

As a creditor, you should note the following:

- The scheme process may require substantial time and resources to bring to fruition.
- There are uncertainties in the process. Even if the scheme is approved by the requisite number of creditors and members, the court may refuse to sanction the scheme if the conduct of meetings lacks procedural fairness or if the scheme offends public policy or is ultra vires. Dissenting creditors will only be bound when the scheme is eventually sanctioned by the court.

[9] *Re Ping An Securities Group (Holdings) Limited* [2021] HKCFI 1394.

[10] *The Joint Provisional Liquidators of BJB Career Education Co Ltd (In Provisional Liquidation) v Xu Zhendong* [2016] HKCFI 1930 at 3.

[11] Companies Ordinance (Cap 622 of the laws of Hong Kong).

- The commencement of the scheme of arrangement process does not trigger a moratorium on civil proceedings[12]. Therefore, before the scheme is eventually sanctioned by the court, a dissenting creditor, even if holding an insignificant portion of the company's debt, can bring a claim or wind up the company.

Mainland-Hong Kong arrangement on mutual recognition and assistance of insolvency proceedings

Many businesses in Hong Kong have close ties with the Mainland. The need for a legal framework for reciprocal cooperation in insolvency between Hong Kong and the Mainland has become increasingly important.

On 14 May 2021, the Hong Kong government and the Supreme People's Court in the Mainland entered into an arrangement on mutual recognition of and assistance to insolvency proceedings (the **Arrangement**)[13]. The Arrangement provides a mechanism whereby three pilot courts (Intermediate People's Courts in Shanghai, Xiamen, and Shenzhen) will consider applications for recognition of and assistance to insolvency proceedings commenced in Hong Kong in respect of companies that have COMI in Hong Kong for at least six months prior to application and have principal assets or business operations or representative offices in one of these pilot areas. Once the Mainland courts recognise the Hong Kong insolvency proceedings, the Hong Kong liquidators, upon application, may take over the property of the debtor in the Mainland and investigate the debtor's affairs. The Mainland courts may also designate local administrators to exercise these powers on request by the liquidator or the creditor.

Likewise, a Mainland administrator may apply to the Hong Kong court for recognition of liquidation, reorganisation, and compromise proceedings commenced in the Mainland.

Outlook – Companies (Corporate Rescue) Bill 2021

Towards the end of last year, the Hong Kong government announced that it would present the Companies (Corporate Rescue) Bill to the Legislative Council in early 2021[14], which introduces a corporate rescue procedure with a statutory moratorium:

- A company that is insolvent or will likely become insolvent may initiate a corporate rescue procedure and appoint a certified public accountant or solicitor as the provisional supervisor. The provisional supervisor will take over the management of the company and act as the company's agent.

- The provisional supervisor will have 45 business days to propose a rescue plan for consideration at the creditor's meeting, and if approved, to implement the plan.

- The commencement of the provisional supervision will bring about a moratorium[15]. However, creditors are not prevented from pursuing against the debtor in other jurisdictions.

While it is unlikely that the bill will be passed in time to apply to the wave of insolvency arising from the current economic downturn, this is still a significant development that major creditors should watch out for.

Conclusion

In summary, where you are owed sums by a defaulting company with an offshore corporate structure, you should:

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[12] In contrast, where a PL is appointed or a winding-up order is made, no action can be continued or commenced against the company except with the leave of the court.

[13] 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.

[14] As of the date of this briefing, the bill has not yet been introduced.

[15] Creditors cannot commence any actions against the company in Hong Kong, subject to specifically exempted proceedings such as criminal proceedings and employment actions.

(1) consider whether restructuring or immediate liquidation would yield better returns and more advantageous recovery by assessing critically the company's restructuring proposal and its financial status;

(2) where you find immediate liquidation is a better route, ascertain, if possible, that the debtor company is indeed insolvent and the debt is not disputed by the company on substantial grounds before issuing the winding-up petition;

(3) consider which venue to bring the insolvency proceedings in light of factors such as the corporate structure of the debtor and the laws on recognition of foreign insolvency proceedings of the jurisdictions where the company's main assets are located;

(4) bring insolvency proceedings in the place of incorporation if Hong Kong-appointed liquidators will not be able to gain control of the main operating subsidiaries overseas or otherwise yield real benefit to creditors;

(5) check if there is any extant winding-up petition issued by other creditors, and if there is, consider appearing on the first petition as supporting creditor, rather than issuing a separate petition which would be viewed unfavourably by the court; and

(6) prepare for an application of adjournment by the company in favour of a restructuring attempt. In such a case, it is important to coordinate with other creditors to assess the credibility of the restructuring proposal and continue to pursue the winding up of the company where the proposed restructuring is not credible.

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