SLAUGHTER AND MAY/

CLIENT BRIEFING

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HK CFA CLARIFIES EFFECT OF EXCLUSIVE JURISDICTION CLAUSES ON THE COURT'S INSOLVENCY JURISDICTION

RE GUY KWOK-HUNG LAM [2023] HKCFA 9

The Hong Kong Court of Final Appeal (**CFA**) has recently in Re Guy Kwok-Hung Lam[1] confirmed that, where a dispute in respect of a petition debt is subject to an exclusive jurisdiction clause (**EJC**), the Hong Kong court should generally hold the petitioner and debtor to their contract and decline to exercise its insolvency jurisdiction, absent countervailing factors and unless the dispute borders on the frivolous or abuse of process. The parties are expected to resolve their dispute over the debt at the forum agreed under the EJC.

In this briefing, we will discuss the CFA's ruling and how the insolvency court has considered the now settled approach in a more recent case involving an arbitration clause.

Re Guy Kwok Hung-Lam

Mr Lam provided a guarantee in respect of loan facilities provided by Tor Asia Credit Master Fund LP (the **Petitioner**) to his companies under a Credit and Guaranty Agreement (the **Credit Agreement**). The Credit Agreement was governed by New York Law and contained an EJC in favour of New York courts, "*for the purposes of all legal proceedings arising out of or relating to*" the Credit Agreement and the other loan documents.

When Mr Lam failed to honour the guarantee, the Petitioner served a statutory demand on him, which is usually a prelude to a bankruptcy petition. However, Mr Lam made no attempt to set aside the statutory demand. The Petitioner then presented a petition against Mr Lam pursuant to section 6B(2) of the Bankruptcy Ordinance (Cap. 6).

While the bankruptcy petition was pending, Mr Lam commenced legal proceedings against the Petitioner in New York, seeking a declaration that there had been no event of default under the Credit Agreement and damages. Meanwhile, he opposed the bankruptcy petition, primarily on the basis that the debt was in dispute and the dispute should be determined by the New York court under the EJC in the Credit Agreement.

Whilst the New York legal proceedings were ongoing, the Hong Kong Court of First Instance (**CFI**)[2], having considered the affidavit evidence, decided that Mr Lam had failed to show a genuine dispute on substantial grounds in respect of the debt, and made the bankruptcy order against Mr Lam. The judge decided that the EJC was only a matter that the court could consider when determining the bankruptcy petition. The court was not bound by the parties' choice of jurisdiction.

The Court of Appeal (**CA**), however, came to a different view and held in favour of Mr Lam (albeit the reasoning of the majority and the minority in the CA differed). Mr Lam at the CA advocated the adoption of the *Lasmos* approach laid down by Harris J in *Re Southwest Pacific Bauxite (HK) Limited*[3]. According to Harris J, a winding up petition should generally be dismissed where the disputed debt arises from a contract which contains an arbitration clause and if the debtor had taken steps to resolve the dispute pursuant to the arbitration clause.

The CA, however, did not specifically endorse the *Lasmos* approach. In deciding in favour of Mr Lam, the majority of the appellant court (with G Lam JA delivering the leading judgment) held that:

- When asking the Hong Kong court to exercise its bankruptcy jurisdiction, the Petitioner was indeed seeking the court's determination on the dispute (albeit on a summary basis), which is a judicial determination falling within the EJC. The EJC was engaged. The court's determination of the substantive case could give rise to an issue estoppel.

[1] [2023] HKCFA 9

[2] Under section 97 of the Bankruptcy Ordinance (Cap. 6), bankruptcy jurisdiction in Hong Kong is conferred on the Court of First Instance.

[3] [2018] HKCFI 426

- The silent concomitant of the EJC is that neither party will bring legal proceedings arising out of or relating to the Credit Agreement in any other forum, including a petition for the bankruptcy of the debtor on the basis of a disputed indebtedness under the Credit Agreement.

- The issue as to whether there was a genuine dispute over the debt should be resolved by the agreed forum before the Hong Kong court deals with the rather separate question of bankruptcy of the debtor under Hong Kong insolvency principles. Indeed, before that, the Petitioner's *locus standi* had yet to be established.

- The policy of law requires parties to abide by their contract, including an EJC. The approach that an EJC should simply be treated as a factor to be considered would effectively render the EJC immaterial or irrelevant.

- Having said that, the court envisaged there might be strong reasons for Hong Kong court to exercise bankruptcy jurisdiction pending the determination of the dispute in the agreed forum.

CFA Decision

On the Petitioner's appeal, the CFA was asked what the proper approach of the Hong Kong court to a bankruptcy petition[4] is where there is an EJC which covers the dispute over the debt concerned and the debt is being disputed.

The Petitioner put much emphasis on a creditor's ordinary entitlement to a bankruptcy order unless the debtor (i.e. Mr Lam) can show that the debt is genuinely disputed on substantial grounds. It submitted that the CFI's approach of considering the EJC merely as one of the factors in determining the petitioner accorded with established principles and the public policy considerations, namely that there was a strong public dimension to the insolvency regime and the CFI was empowered and mandated by statute to ascertain if the petitioner has *locus* under the Bankruptcy Ordinance. The Petitioner called this the "Established Approach".

Whilst not disputing the public policy considerations informing the insolvency regime, Mr Lam, however, argued that the question of *locus* is anterior to the question of whether the court should exercise its discretion to make a bankruptcy order and that the public policy considerations did not come into play until the dispute over the debt is resolved. Hong Kong courts therefore should not entertain a winding up petition if the parties have contractually agreed to submit their disputes to a specified jurisdiction unless there are strong reasons otherwise.

The CFA confirmed that parties cannot contractually exclude the Hong Kong court's bankruptcy jurisdiction. This means that whilst the parties have agreed to resolve their dispute via a specified forum, that itself would not bar one of the parties from seeking a winding up order from a Hong Kong court.

A creditor may seek a winding up order from the insolvency court pursuant to the insolvency law in Hong Kong. It is established that, absent an EJC or an arbitration clause, the petitioner will ordinarily be entitled to a bankruptcy order if the relevant debt is not subject to a *bona fide* dispute on substantial grounds. However, this established approach is not applicable where there is an EJC which governs how the parties should resolve their dispute over the debt which gives rise to the petition.

The CFA dismissed the Petitioner's appeal and determined that absent countervailing factors, the parties should resolve their dispute over the debt as per the EJC:

- The determination of whether a debt is *bona fide* disputed on substantial grounds is a '*threshold question*'. The court has discretion to decline jurisdiction to determine this threshold question.

- The fact that the parties agreed to have all their disputes under the agreement giving rise to the debt be determined exclusively in another forum enlivens the discretion to decline jurisdiction. The public policy interest in holding parties to their agreements comes into play.

- The CFI, when deciding that there was no *bona fide* dispute on substantial grounds, undertook the equivalent of a summary judgment determination which the parties had already agreed to be made by another forum. The petitioner could sue on the debt and apply for summary judgment there. The public interest in

[4] The principles in Re Guy Kwok-Hung Lam also apply to winding-up petitions in the case of corporate insolvency. References in this briefing to bankruptcy orders includes references to winding up orders and vice versa.

the legislative scheme for bankruptcy jurisdiction is unlikely to be adversely affected by the time required for the foreign proceedings, especially if there is no competing creditor.

- The exercise of the discretion to decline jurisdiction to determine the *bona fides* and substance of a dispute about the petition debt is multi-factorial. While a 'strong cause' test (as referred to by the CA) is indicative, it should not obscure the range of considerations relevant to the court's discretion.

- However, examples of factors which may persuade a Hong Kong court to depart from the above approach include the risk of insolvency affecting third parties and the fact that the dispute is frivolous and an abuse of process.

The CFA was not asked to (and therefore did not) consider the question as to whether the EJC would require bankruptcy proceedings undertaken by the Petitioner against Mr Lam to be instituted in New York. Therefore, it would be up to the CFI to decide whether it should exercise its insolvency jurisdiction in favour of the Petitioner if it is proved in the New York court that Mr Lam has no genuine defence to the claim under the Credit Agreement and if the Petitioner issues a fresh bankruptcy petition.

Application of the CFA decision

The decision concerns the proper approach to petitions where an EJC is involved and the appropriate exercise of the court's discretion to decline the exercise of insolvency jurisdiction. Whilst noting that G Lam JA at the CA referred to the authorities on arbitration provisions which raise issues similar to those raised by an EJC, the CFA also noted that the issues in the two scenarios are not identical.

Therefore, it is not surprising that in a subsequent case, *Re Simplicity & Vogue Retailing (HK) Co Ltd*[5], the CFI decided that the approach in *Re Guy Kwok-Hung Lam* does not apply in the case of an arbitration clause.

In *Re Simplicity*, Linda Chan J held that, as far as arbitration clauses are concerned, the court's approach is guided by two CA judgments in *But Ka Chon*[6] and *Sit Kwong Lam*[7], and in deciding whether to exercise its discretion to dismiss or stay a petition where the parties have agreed to an arbitration clause, the court will also consider whether the requirements in *Lasmos* are satisfied. Indeed, her Ladyship did not consider it right that, if there is an arbitration clause in the agreement which gave rise to the petitioning debt, the court should invariably refuse to consider the merit of the defence raised by the debtor and require the parties to litigate their dispute pursuant to their arbitration agreement. It was considered that where the debtor raises a substantive defence, the insolvency court should consider whether the defence is one which can readily be shown to be wholly without merit. If the court can come to that view without considering any detailed arguments or disputed evidence, it would have no difficulty in concluding that the "defence" is one which "*borders on the frivolous or abuse of process*" even if the approach in *Re Guy Kwok-Hung Lam* applies.

In this regard, we note, however, that the CFA (while not deciding on the issue) in *Re Guy Kwok-Hung Lam* commented that a dispute which is the subject of an arbitration provision may fall within the jurisdiction of the court but in such a case the court is required by section 20 of the Arbitration Ordinance (Cap. 609), to refer the parties to arbitration upon the request of a party unless the arbitration agreement is null and void, inoperative or incapable of being performed. In such case, the court has no choice but to stay the legal proceedings.

Takeaways

Considering the CFA decision in *Re Guy Kwok Hung Lam*, creditors would tread with caution when considering whether to present a winding up petition in Hong Kong where the contract which gives rise to the debt concerned has an EJC in favour of a foreign jurisdiction and if it seems that the debtor is likely to dispute the debt.

It is important to conduct a realistic assessment of the strength of the creditor's claim against the debtor, including any reasonable defence that the debtor may have. It could be a waste of time and costs to issue a winding up petition if there is a genuine dispute over the debt which should be resolved via the agreed forum, unless there are countervailing reasons for the Hong Kong court to grant a winding up order pending

[5] [2023] HKCFI 1443

[6] [2019] HKCA 873

[7] [2019] HKCA 1220

determination of the dispute. Commencing insolvency proceedings just to assert pressure on the debtor could constitute an abuse of process. Legal advice is therefore warranted.

Cases involving arbitration clauses should also be considered with caution given that the insolvency court may take an approach different from that set out in *Re Guy Kwok Hung Lam*.

CONTACTS

WYNNE MOK
PARTNER
T: +852 2901 7201
E: wynne.mok@slaughterandmay.com

RALPH SELLAR
PARTNER
T: +852 2901 7204
E: ralph.sellar@slaughterandmay.com

JASON CHENG
ASSOCIATE
T: +852 2901 7211
E: jason.cheng@slaughterandmay.com

AUDREY LI
ASSOCIATE
T: +852 2901 7209
E: audrey.li@slaughterandmay.com

SHIRLEY CHOI
ASSOCIATE
T: +852 2901 7292
E: shirley.choi@Slaughterandmay.com

London
T +44 (0)20 7600 1200
F +44 (0)20 7090 5000

Brussels
T +32 (0)2 737 94 00
F +32 (0)2 737 94 01

Hong Kong
T +852 2521 0551
F +852 2845 2125

Beijing
T +86 10 5965 0600
F +86 10 5965 0650

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