COMMON SENSE IN COMMON LAW RECOGNITION

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This article picks up on some of the themes discussed in one of the INSOL Virtual 2021 offshore panel discussions, titled *"Common sense in common law recognition – how Offshore Courts and the Hong Kong Courts can be good neighbours".*

In that panel, the speakers (Ian Mann – Harneys Hong Kong; Grant Carroll – Ogier BVI; Chris Farmer – KPMG BVI; Eleanor Fisher – EY Cayman; and Shelley White – Walkers Cayman) discussed recent developments in the law regarding the appointment of 'light-touch' provisional liquidators (PLs) in Offshore jurisdictions to facilitate restructurings, and the recognition and assistance to such appointees commonly provided by the Hong Kong Courts.

Introduction

For years, the Offshore and Hong Kong Courts have worked together very well, to facilitate expeditious and efficient restructurings of a number of offshore-incorporated entities, with economic links to Hong Kong. In general, these efforts have benefitted those entities' creditors, who would otherwise stand to receive smaller sums resulting from the fire-sale of company assets achieved through liquidation.

One commonly-used technique is the *Z-Obee* technique[1]. Its use stems from the fact that the Hong Kong Courts may not appoint PLs to restructure a company's debts.

To meet this demand, a practice has emerged of seeking the appointment of PLs in the Offshore jurisdiction of incorporation. Then, the PLs seek recognition and assistance from the Hong Kong Court, on terms that enable them to pursue a restructuring in Hong Kong (e.g. through a scheme of arrangement there[2]).

Although less common, there are also examples of 'reverse recognition', where appointments are made by the Hong Kong Court over offshore companies, and those officeholders are then recognised and assisted by the courts in the country of incorporation (e.g. see *China Agrotech – FSD 157 of 2017).*

Light-touch PLs

Often, the appointment of PLs by the Offshore Courts is made on a 'light-touch' basis. This means that, rather than replacing a company's board of directors, the PLs will be appointed alongside them. They will not displace the directors' day-to-day functions, but will supervise and assist them to carry out a restructuring. They may also be required to consult on and approve any proposed transactions that fall outside the company's ordinary course of business.

Such applications are common in the Cayman Islands and Bermuda, where there are well-trodden statutory bases for such appointments. Those appointments come with statutory stays on proceedings, which permit breathing room for restructuring options to be explored.

More recently, in the 2019 case of *Constellation Overseas Ltd*[3], the BVI Court also confirmed its ability to appoint light-touch PLs at common law. Most BVI cases since then have proceeded on a consensual basis, so the availability and scope of consequent stays has not yet been tested.

Stays in Hong Kong

The utility of stays granted by the Offshore Courts will depend on whether a company's creditors are subject to the jurisdiction of that Court. If they are not, then it may have limited effect. An unrestricted creditor could still choose to petition the Hong Kong Court for the winding-up of such a company (as long as the three 'core requirements' governing petitions in respect of foreign companies are met[4]).

1 Following the decision in that case [2018] 1 HKLRD 165, the first in which a foreign incorporated listed company was put into light-touch provisional liquidation in its place of incorporation (Bermuda) and the PLs introduced a scheme of arrangement in Hong Kong.
2 See, e.g. the form of order made in *Hsin Chong Group Holdings Ltd* [2019] HKCFI 805
3 BVIHC (Com) 2018/0206, 0207, 0208, 0210, 0212
4 Following the Hong Kong Court of Final Appeal case of *Kam Leung Siu Kwan v Kam Kwan Lai* (2015) 18 HKCFAR 501, these are that:
1. there is a sufficient connection with Hong Kong, but this does not necessarily have to consist of the presence of assets within the jurisdiction;
2. there is a reasonable possibility that the winding-up order will benefit those applying for it; and
3. the Hong Kong Court must be able to exercise jurisdiction over one or more persons in the distribution of the company's assets.

As the Hong Kong Court confirmed in *FDG Electric Vehicles*[5] , even if an overseas PL appointment is recognised, this will not bring with it a general stay of local proceedings.

Instead, if faced with a Hong Kong petition, it will fall to the company to persuade the Hong Kong Court to adjourn it, in accordance with the normal principles governing such applications. As indicated by *Lerthai Group*[6] and the cases that preceded it, when considering such applications, the Hong Kong Court will have regard to the following factors:

a) a qualitative assessment of the number of creditors for and against a winding-up order;

b) the reasons proffered by the supporting and opposing creditors; and

c) the feasibility of any proposed restructuring (the evidence on this point will have to be all the more compelling if no creditor supports the adjournment of a petition).

Accordingly, once PLs have been appointed, it remains imperative to engage with creditors as early and fully as possible and to take substantive steps towards a restructuring. If there is little evidence of progress between the appointment of PLs and any later adjournment application, the Hong Kong Court may well take a sceptical view of the feasibility of any proposed restructuring.

Applications aimed at obtaining a *de facto* stay for the benefit of the company

In the context of such recognition and adjournment applications, the Hong Kong Court has grappled with a number of recent (March – May 2021) cases, in which it has raised concerns that the *Z-Obee* technique is being abused, and that companies are using it to try to stave-off meritorious winding-up petitions, for the benefit of shareholders and management and to the detriment of creditors.

These cases are *Lamtex*[7], *Ping An*[8], *China Bozza*[9], and *Victory City*[10]. In them, the Hong Kong Court (in each case, Harris J) has made it clear that it will give short shrift to such efforts.

As observed by the Hong Kong Court, these cases all have a number of common features, including:

- defensive applications by the companies in their Offshore jurisdictions, only after steps towards winding-up were taken by their creditors (three petitions and one statutory demand);
- the offshore applications were made on little or no notice to the creditors in question;
- in the majority of cases, there was little evidence of the viability of any restructuring, or that substantive efforts had been made towards one, including any meaningful engagement with creditors. As Harris J put it in *Bozza* (at paragraph 25);

  Practitioners should be alive to the need for evidence to be filed that provides an informed and candid description of a company's financial position and what is envisaged to be the most likely solution to its problems…

  … Simply referring to a possible "debt restructuring" and treating the expression as a kind of magical incantation, the recitation of which will conjure up an adjournment of the petition is as inadequate as it is facile.

- in at least some of these cases, the companies' directors appeared not to appreciate that, upon entering into the zone of insolvency, their fiduciary duties became owed to the companies' creditors. For example, in *Bozza*, Harris J. observed with concern, a directors' resolution that the referenced offshore PL application being in the interests, *"of the company and its shareholders as a whole,"* rather than the interests of creditors;
- all four cases involved the same insolvency practitioners and, it appears, the same lawyers. As Harris J put it in *Victory City* (paragraph 23):

  All four cases seem to exhibit a failure to understand the proper scope and the use of soft-touch provisional liquidation at least viewed from the perspective of Hong Kong law and practice.

It may not be surprising that the Hong Kong Court reacted to these cases with well-founded scepticism. But what may be of wider consequence, is that in the first of these cases, *Lamtex*, the Hong Kong Court also considered whether primacy should always be given to the insolvency proceedings in a company's country of incorporation, or whether it should follow Singapore's earlier example in the case of *Opti-Medix*[11] and embrace the use of COMI when considering such issues.

It remains to be seen to what extent these thoughts remain constrained to the rather unappealing fact patterns of the four cases above, or whether their effects will ultimately be felt more widely.

Raising the threshold test offshore?

At the same time, possibly influenced by similar considerations, some Offshore Courts appear to be moving towards raising the threshold test for the appointment of light-touch PLs.

For example, in the recent case *Midway Resources*[12], the Court adjourned a PL application to allow for more detailed evidence on the viability of a potential restructuring to be presented, and crucially also to allow the company's creditors to have a sufficient opportunity to appear before the Court if they so wished. Similarly, in *Victory City,* the Bermuda Court ultimately replaced the original PLs and wound-up the company.

These are positive developments. Many of the factors that appear to have irked the Hong Kong Court in the cases discussed above might well have been mitigated if the affected creditors had sufficient opportunity to make their views known to the Offshore Courts in question.

Alternatively, it may be that there is a greater role for court-to-court communication to play in these cases, where each court is, after all, seeking to safeguard the interests of the same creditors.

What is clear is that this is a developing area of law, and one which practitioners would be well-advised to monitor. A good starting point is to watch the panel discussion!

5 [2020] HKCFI 2931
6 [2021] HKCFI 207
7 [2021] HKCFI 622
8 [2021] HKCFI 651
9 [2021] HKCFI 1235
10 [2021] HKCFI 1370
12 [2016] SGHC 108
13 FSD 51 of 2021 (NSJ)