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# Hong Kong/Mainland Mutual Recognition Framework for Insolvency and Restructuring: What does it mean for Hong Kong restructuring & insolvency?

**Attorneys**
Kathleen Aka

On 14 May 2021, the Supreme People's Court of the People's Republic of China ("SPC") and the Government of the Hong Kong Special Administrative Region ("HKSAR") signed the *Record of Meeting 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").

A framework for mutual recognition and assistance between the Hong Kong and Mainland courts in respect of insolvency and restructuring proceedings has been a long-anticipated development, particularly as neither HKSAR nor the Mainland have enacted legislation adopting the UNCITRAL Model Law on Cross-Border Insolvency ("Model Law"). To date, there does not appear to have been any case in which Mainland courts have granted formal recognition of Hong Kong insolvency proceedings, and it was not until early 2020 that a Hong Kong court granted an order for recognition and assistance to administrators of a company in bankruptcy in Mainland China for the first time, applying common law principles of recognition.[1]

At a high level, the Record of Meeting, supplemented by the SPC's Opinion and the HKSAR Government's Practical Guide, (together, the "Recognition Framework") provides a mechanism for:

- Hong Kong liquidators or provisional liquidators to apply to the Intermediate People's Courts in Shanghai, Xiamen and Shenzhen for recognition and assistance in respect of Hong Kong insolvency and restructuring proceedings; and
- Mainland bankruptcy administrators to apply to the Court of First Instance of the High Court of HKSAR for recognition of Mainland bankruptcy and reorganisation proceedings.

According to a press release issued on 14 May 2021 by the HKSAR Government, the Recognition Framework "facilitates the rescue of financially troubled businesses, and provides better protection of the assets of the debtor company as well as the interests of the creditors, and is hence conducive to the promotion of an orderly and efficiency insolvency regime". The HKSAR Government believes that the new framework "will give additional assurance to investors and further improve the business environment in the Mainland and Hong Kong".

Of particular interest to those focused on corporate rescue is the stated inclusion in the framework of reorganisation and restructuring proceedings, which the HKSAR Government has indicated is to encourage "the use of restructuring of debts to revive businesses … [which] may open up more opportunities for the debtor company to look for a successful rescue".

In this Alert, we consider how useful and effective the new Recognition Framework is likely to be in aid of Hong Kong corporate restructuring and insolvency proceedings being recognised by Mainland courts.

## A pilot program with geographic limitations

One point to note from the outset is that this is a pilot program, limited to three specified Mainland jurisdictions: Shanghai, Xiamen and Shenzhen. According to the HKSAR Government press release, these jurisdictions have been selected on the basis that they have "close trade ties with Hong Kong" and are "popular choices for investments from Hong Kong".

An application for recognition of a Hong Kong insolvency or restructuring proceeding must be supported by evidence that the debtor's principal assets are located in a pilot area, or that the debtor has a place of business or a representative office in a pilot area.

As a practical matter, it may be difficult for a Hong Kong liquidator or provisional liquidator to compile sufficient evidence to prove the location of the debtor's principal assets in the Mainland. This is more likely to be an issue in respect of applications for recognition of liquidations, rather than restructuring proceedings, given that, in the case of the latter, a certain level of cooperation by the company's management can be expected.

## Centre of Main Interests (COMI)

The debtor company must have had Hong Kong as its centre of main interest (COMI) continuously for at least six months in order for an application for recognition to be made to the Mainland courts. This may, in practice, prove to be a difficult element to satisfy in the case of Hong Kong holding companies of groups with extensive Mainland operations.

For the purpose of determining COMI, the Recognition Framework has adopted a principle (albeit using different terminology) apparently consistent with that applied in jurisdictions which have adopted the Model Law. Under the Model Law framework, there is a rebuttable presumption that a debtor has its centre of main interest in its place of incorporation, but this presumption may be rebutted if there are factors, objective and ascertainable by third parties, which establish that the debtor's centre of main interest is, in fact, other than its place of incorporation. Such factors might include the location of the company's decision-makers, head office, and principal business activities, assets and economic interests. Similarly, under the Recognition Framework, COMI "generally means the place of incorporation of the debtor," but the Mainland courts will take into account other factors such as the location of the debtor's principal place of business, principal office and principal assets.

Applying Model Law jurisprudence, establishing a debtor's COMI can in some instances be a fairly simple exercise. For example, it is not particularly difficult to rebut the COMI presumption in a case involving a debtor incorporated in an offshore "letterbox" jurisdiction which conducts no business administration or activities in its place of incorporation. Other cases, however, require analysis of a more complex factual matrix. This is likely to be the case in respect of Hong Kong (or offshore) incorporated companies with decision-makers and principal offices spread across Hong Kong and the Mainland, and principal business activities and economic interests in the Mainland.

## Standing of applicant and nature of proceedings

*Applicants – Hong Kong liquidators and provisional liquidators only*

Only liquidators or provisional liquidators in collective insolvency proceedings commenced in accordance with the *Companies (Winding Up and Miscellaneous Provisions) Ordinance and Companies Ordinance and Companies Ordinance* ("HK Administrators") have standing to make an application for recognition and assistance to the Mainland courts. Foreign liquidators and provisional liquidators would lack standing to make an application, as would directors of a debtor company. The relevance of this will become apparent in the discussion to follow regarding recognition of schemes of arrangement.

*Schemes of arrangement* – Re Legend *strikes again?*

Whilst there is an interesting (albeit, nowadays, likely academic) argument as to whether schemes of arrangement may properly be characterised as "collective proceedings", the Recognition Framework helpfully makes express reference to the inclusion of schemes of arrangement as one of the types of proceedings capable of recognition.

At first blush, this seems to represent a significant and positive development for restructuring Hong Kong companies with Mainland operations. However, in order to obtain recognition of a Hong Kong-sanctioned scheme of arrangement by the Mainland courts, the scheme must be one "promoted by a liquidator or provisional liquidator", as opposed to one promoted by the company under the direction of its board. That is, it appears that a scheme of arrangement petitioned by a liquidator or provisional liquidator under section 673(4) of the *Companies Ordinance* is capable of recognition under the Recognition Framework, whereas a scheme of arrangement petitioned by a company or its creditors under section 673(3) is not.

Herein lies a problem: it is a well-established principle of Hong Kong insolvency law, following the *Re Legend*[2] decision, that provisional liquidators cannot be appointed by the Hong Kong courts solely for the purpose of enabling a corporate restructuring to take place.[3] The "soft touch" provisional liquidation commonly used in offshore jurisdictions to impose a stay on creditors whilst a restructuring plan is developed and implemented is not a feature of Hong Kong insolvency law.

Even if a debtor has its COMI in Hong Kong and its place of incorporation in a jurisdiction where soft touch provisional liquidations are available (such as the Cayman Islands or Bermuda), it is unlikely that Mainland recognition could be obtained. Although a debtor may be able to initiate the appointment of soft touch provisional liquidators in its place of incorporation, and thereafter seek recognition of that appointment in Hong Kong, a foreign provisional liquidator does not have standing to petition for the sanction of a scheme of arrangement under section 673(2) of the *Companies Ordinance*.[4]

With the Hong Kong courts having no ability to appoint soft touch provisional liquidators, and recognition by the Mainland courts being limited to schemes of arrangement "promoted by a liquidator or provisional liquidator", the circumstances in which schemes of arrangement will be eligible for recognition in the Mainland may prove to be quite narrow. This is not so much a deficiency in the Recognition Framework itself, but rather is another instance highlighting Hong Kong's lack of a much-needed, and long overdue, formal corporate restructuring regime.

*Collective proceedings – individual creditor enforcement actions are excluded*

As is the case under the Model Law, an application under the Recognition Framework may only be made in respect of Hong Kong insolvency or restructuring proceedings which are collective proceedings. The term "collective proceeding" generally refers to "a process of collective enforcement of debts for the benefit of the general body of creditors".[5] Such proceedings can be contrasted with insolvency processes such as receiverships, which are not collective in nature insofar as they are not undertaken for the benefit of the general body of creditors.

*Winding up – Compulsory and creditors' voluntary only?*

Insolvency proceedings commenced in accordance with the *Companies (Winding Up and Miscellaneous Provisions) Ordinance* and *Companies Ordinance* are capable of recognition under the Recognition Framework. Compulsory winding up and creditors' voluntary winding-up proceedings are expressly covered, but the Recognition Framework is silent as to recognition of members' voluntary winding-up proceedings.

In *Singularis Holdings Ltd v PricewaterhouseCoopers* [2015] AC 1675, the Privy Council, in obiter, espoused the view that common law recognition of foreign insolvency proceedings would not extend to voluntary liquidations. That position has not been adopted in Hong Kong or Singapore, but it remains to be seen how the Mainland courts might approach the issue for the purpose of applying the Recognition Framework.

## Efficiency

The Recognition Framework is intended to be a fast and efficient process. Upon receipt of an application for recognition, the relevant Mainland court will notify interested parties within five days, and any objections from interested parties are due within seven days thereafter. If objections are received, then the Mainland court will decide whether it is necessary to conduct a hearing. There is no stipulated time period within which any such hearing must be held or a decision made, but upon making a decision to recognise a Hong Kong insolvency proceeding, it will be announced by the court within five days.

In terms of timing, applicants should bear in mind that the Mainland court will require that certain documents (such as the materials showing the debtor's centre of main interests), if issued outside the Mainland, be certified in accordance with the laws of the Mainland. In practice, the certification process, involving notarisation and legalisation of documents, may result in lengthy delays, particularly during the COVID-19 pandemic. In addition, non-Chinese language materials must also be submitted with a Chinese translation.

## Moratoria

There is no automatic stay on creditors' rights or actions against the debtor or its assets upon the filing of an application for recognition, but the HK Administrator can apply to the Mainland court for preservation orders in accordance with Mainland law.

## Recognition

The Mainland courts will not recongise or assist Hong Kong insolvency proceedings if:

- the COMI of the debtor is not in HKSAR, or has not been in HKSAR continuously for the preceding six months;
- Article 2 of the *Enterprise Bankruptcy Law of the People's Republic of China* ("EBL") (which essentially requires that the debtor be unable to pay its debts and have a deficiency of net assets, or appear to lack the ability to pay its debts) is not satisfied;
- Mainland creditors are unfairly treated;
- there is fraud;
- there is any other circumstance where the Mainland court considers that recognition or assistance should not be rendered; or
- the Mainland court considers that recognition or assistance violates the basic principles of Mainland law or offends public order or good morals.

Some of these elements appear to confer an incredibly broad discretion on the Mainland court to reject an application for recognition and assistance of a Hong Kong insolvency proceeding; however, we will need to wait and see how the Mainland courts approach these matters in practice before we can form any view as to whether any or all of these elements pose particular difficulties.

If Hong Kong insolvency proceedings are recognised by a Mainland court, then:

1. payment of debts by the debtor to individual creditors are invalid;
2. current civil actions or arbitrations are stayed, but may resume once the HK Administrator takes control of the debtor's property;
3. preservation orders which may have been granted are lifted, and any procedure for execution against the debtor's assets are suspended;
4. the Mainland court may, upon application, permit the HK Administrator the ability to:
    a. take control of the property, seals, accounts, and books and records of the debtor;
    b. investigate the financial positon of the debtor;
    c. make decisions as to the day-to-day management of the debtor, its assets and its business;
    d. manage and dispose of the debtor's property;

e. bring or defend legal actions, arbitrations or other legal proceedings on the debtor's behalf; and

f. adjudicate creditors' claims against the debtor.

Notwithstanding the above powers, in the absence of separate approval of the Mainland court, a HK Administrator is not permitted to do anything which would result in a waiver of property rights, the creation of security on property, the making of a loan, a transfer of property out of the Mainland, or a disposal of property that has a major impact on creditors' interests.

## Uncertainty after recognition

The Mainland court may terminate or modify any recognition or assistance it has granted "upon discovering any circumstances that may impact on the recognition of and assistance" of the Hong Kong insolvency proceeding. There is no guidance as to what "circumstances" could lead to a termination or modification of the grant of recognition or assistance.

Further, upon an application by the HK Adminstrator or any creditor, the Mainland court may designate the appointment of a Mainland administrator. If that occurs, then all of the powers outlined in paragraph 4 above are exercisable by the Mainland administrator, and the EBL shall apply to the affairs and property of the debtor in the Mainland. It is troubling that such an application may be made by a creditor, and it is not clear in what circumstances the Mainland court would entertain such an application. If readily applied, this provision could effectively undermine the spirit of mutual cooperation contemplated by the Recognition Framework. However, until we see if and how this provision is used and applied in practice, it is difficult to predict its full impact.

## Conclusion

The Recognition Framework does present an opportunity for the Hong Kong and Mainland courts to foster cooperation and forge closer ties in matters relating to cross-boundary insolvency and restructuring. How successful and effective the framework will be depends to a great extent on how the courts apply the broad principles in practice.

Unfortunately, the introduction of this Framework has once again highlighted the inadequacy of HKSAR's current patchwork approach to effecting corporate restructuring, relying on common law principles and insolvency legislation, which is not fit for purpose. Until this underlying deficiency in our corporate restructuring framework is addressed through legislative changes, the success of any attempt at mutual cross-boundary cooperation will inevitably be limited.

1. *See Re CEFC Shanghai International Group Ltd* [2020] 1 HKLRD 676.
2. *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192.
3. For an order appointing a provisional liquidator to be made under section 192 of the *Companies (Winding Up and Miscellaneous Provision) Ordinance*, the appointment must be for the purposes of a winding up, and the court needs to be satisfied that a winding-up order is likely to be made, and that the appointment is necessary for the protection of assets.
4. *See Re Z-Obee Holdings Ltd* [2018] 1 HKLRD 165, 169.
5. *Re Lines Bros Ltd* [1983] Ch 1, 20.