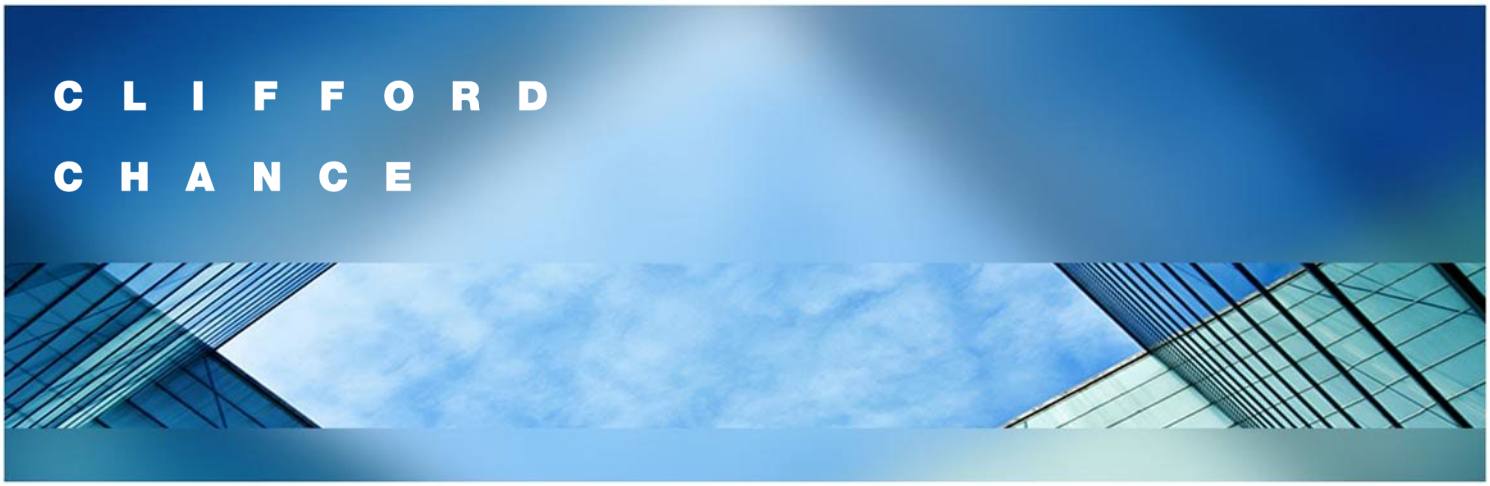

AVAILABILITY OF BANKRUPTCY AND INSOLVENCY RELIEF IN THE CASE OF EXCLUSIVE JURISDICTION CLAUSES AND DISPUTED DEBTS

In the judgment of *Re Guy Kwok-Hung Lam* [2023] HKCFA 9 handed down on 4 May 2023, the Court of Final Appeal in Hong Kong unanimously upheld the majority decision of the Court of Appeal that in an ordinary case where the underlying dispute over the petition debt is subject to an exclusive jurisdiction clause in favour of a foreign court, the Hong Kong court should decline bankruptcy or insolvency jurisdiction unless there are strong reasons to the contrary. This has important implications for parties who wish to invoke the Hong Kong court's bankruptcy or insolvency jurisdiction and parties will need to carefully consider their jurisdiction and dispute resolution clauses and think through the forum(s) for enforcement before entering into their contracts.

Key issues

- An exclusive jurisdiction clause will ordinarily be respected where the underlying dispute over the petition debt is subject to it; the court should decline its bankruptcy or insolvency jurisdiction unless there are strong reasons to the contrary.
- Whether an arbitration clause will similarly be upheld in the same context, following the *Lasmos* approach, is yet to be determined. However, this Court of Final Appeal decision demonstrates the importance the court places on party autonomy.
- Parties need to carefully consider the jurisdiction and dispute resolution clause during contract negotiation if they wish to preserve the right to invoke the court's bankruptcy or insolvency jurisdiction and to avoid wasted time and costs in debt recovery.

INTRODUCTION AND KEY TAKEAWAYS

The Court of Final Appeal (the "**CFA**") in Hong Kong has ruled in favour of parties' autonomy and its decision promotes consistency in the treatment of exclusive jurisdiction clauses in the context of ordinary court actions and bankruptcy and insolvency proceedings.

In the judgment of *Re Guy Kwok-Hung Lam* [2023] HKCFA 9 handed down on 4 May 2023, the CFA unanimously upheld the majority decision of the Court of Appeal (the "**CA**") that in an ordinary case where the underlying dispute of the petition debt is subject to an exclusive jurisdiction clause in favour of a foreign court ("**EJC**"), the Hong Kong court should decline jurisdiction in the face of a bankruptcy or insolvency petition unless there are strong reasons to the contrary (the "**Strong Cause Test**").

This means that parties need to carefully consider the jurisdiction and dispute resolution clause and think through the forum(s) for enforcement before entering into their contracts. It may not be enough to rely on boilerplate clauses and parties should be mindful not to draft away the traditional right to petition the court for bankruptcy or insolvency relief. As parties will be held to their bargain, ignoring the agreed dispute resolution forum might lead to additional and wasted time and costs, and even potentially a counterclaim for damages for breach of the EJC, at the time of debt recovery.

FACTS

On the facts, the petitioner (a limited partnership registered in the Cayman Islands), the company (a Cayman company holding a group of companies providing aged care services in the Mainland) and the guarantor (the sole shareholder and director of the company who is a Hong Kong resident) entered into a Credit and Guaranty Agreement dated 11 July 2017 (the "**Agreement**") pursuant to which the petitioner advanced term loans in the amount of US$29.5 million (the "**Loans**") to the company and the guarantor guaranteed, as primary obligor, the full payment of all amounts due from the company without demand or notice. The EJC in the Agreement provided for the exclusive jurisdiction of the New York courts for "*all legal proceedings arising out of or relating to this Loan Agreement or other Loan Documents or the transactions contemplated*" by the said documents.

The company and the guarantor allegedly defaulted in repaying the Loans and fulfilling the guaranteed obligations respectively. The petitioner issued a statutory demand and presented a bankruptcy petition against the guarantor.

COURT OF FIRST INSTANCE JUDGMENT

At the first instance hearing of the bankruptcy petition in June 2021, the Court of First Instance ("**CFI**") followed the "established approach", whereby a bankruptcy or winding up order would ordinarily be made if the petition debt is not subject to a bona fide dispute on substantial grounds. The CFI made a bankruptcy order against the guarantor on the basis that he had failed to show a bona fide dispute on substantial grounds in respect of the petition debt. The CFI held that an EJC does not prevent a bankruptcy or winding up petition from being presented and the EJC is only one factor to be considered when determining the petition. The CFI took the view that it would be a pointless exercise to require the petitioner to first obtain a judgment in the agreed forum in circumstances where there is no real dispute on the petition debt.

COURT OF APPEAL JUDGMENT

The CA overturned the CFI's decision and dismissed the bankruptcy petition in view of the EJC. In the majority decision, G Lam JA reviewed the law on EJCs and drew comparisons with the effect of arbitration clauses on winding up petitions following the decision of Harris J in *Re Southwest Pacific Bauxite (HK) Ltd* [2018] 2 HKLRD 449 ("**Lasmos**"). The CA laid down the Strong Cause Test based on the following reasoning:

- **The bona fide dispute test and engagement of the EJC in this case**. The hearing of a winding up or bankruptcy petition is in effect "a summary judgment procedure" inviting the court to decide whether there is a bona fide dispute on substantial grounds over the petition debt. Such judicial determination of the parties' rights under the Agreement falls within the scope of the EJC in question and should be determined by the New York courts. If the determination is made by the Hong Kong court in its bankruptcy jurisdiction, it is capable of giving rise to issue estoppel.
- **Same approach as ordinary actions should be adopted in bankruptcy and winding up proceedings**. The same approach to a stay of an ordinary action based on an EJC should be adopted in relation to bankruptcy and winding up proceedings. Whilst bankruptcy and winding up are class remedies under a statutory regime, the anterior question of whether the petitioner is a creditor in the sense that a debt is due should

be determined in the agreed forum, and if it is not so established, the petitioner would not be entitled to present the petition in the first place. There are strong policy reasons to hold parties to their contractual bargain including in the form of EJCs. Otherwise, it would be incoherent in law that a party bound by an EJC in favour of a foreign court could not proceed with an ordinary action in Hong Kong, but would be able to resort to the more draconian measure of bankruptcy or winding up.

- **Stay or dismissal of bankruptcy or insolvency proceedings unless strong reasons to the contrary**. The approach laid down by the CA is that where the petition debt is disputed and the parties are bound by an EJC in favour of a foreign court, the petition should not be allowed to proceed pending the determination of the dispute in the agreed forum, unless there are strong reasons otherwise. In other words, the court in exercising its bankruptcy or insolvency jurisdiction should not adopt the "established approach" of considering whether there is a bona fide dispute over the petition debt.
- **The court may allow a bankruptcy or insolvency petition to proceed if there are strong reasons to do so.** Whilst the CA stated that it is not possible or desirable to define "strong reasons", it did indicate some examples including where the debtor is incontestably and massively insolvent apart from the disputed petition debt, or where there are other creditors seeking winding up whose debts are not subject to EJCs pointing to foreign forums.

On the facts of this case, the petitioner had not shown strong reasons why the petition should not be stayed or dismissed. The CA therefore dismissed the bankruptcy petition.

COURT OF FINAL APPEAL JUDGMENT

At the CFA, the petitioner (Appellant) argued for the "established approach" adopted by the CFI, whilst the guarantor (Respondent) contended for the majority reasoning of the CA, which was criticised by the petitioner as undermining the policy of the statutory bankruptcy regime.

The CFA first clarified that the bankruptcy jurisdiction of the Hong Kong courts is not amendable to exclusion by contract. However, contracts, including EJCs, inform the court's discretion to decline to exercise its jurisdiction. In general, determination of issues relating to the merits which could give rise to issue estoppel or *res judicata* should not take place in a decision on the discretion to exercise jurisdiction.

The CFA recognised that in the context of a bankruptcy or winding-up petition where the underlying dispute over the petition debt is covered by an EJC pointing to a foreign court, both public policies of holding parties to their agreements and upholding the legislative bankruptcy or insolvency scheme should be considered in the court's exercise of its discretion. In the present case where there is no evidence that interests of parties other than the petitioner and the guarantor are at risk, the significance of the latter policy is much diminished. The concern is further lessened by the availability to the petitioner of obtaining summary judgment in New York.

Ultimately, the CFA affirmed the majority decision in the CA. In the case of an applicable EJC where the parties have agreed to have all their disputes giving rise to the debt be determined exclusively in another forum, the "established

approach" is displaced and the parties should be held to their contract absent countervailing factors, such as the risk of insolvency affecting third parties or that the dispute is frivolous or an abuse of process. The CFA described the Strong Cause Test as "in some sense multi-factorial" and emphasised the range of considerations relevant to the court's discretion.

HOW THE CASE IMPACTS ON THE STATUS OF LASMOS

The *Lasmos* decision largely adopted the approach taken in the English decision of *Salford Estates (No 2) Ltd v Altomart Ltd (No 2)* [2015] 1 Ch 589, both of which have sparked controversy for restricting creditors' rights and the availability of winding up as a remedy for them.

- The *Salford* approach provides that if the petition debt is disputed or not admitted, and the dispute is subject to an arbitration agreement, the court should exercise its discretion to stay or dismiss the winding up proceedings save in wholly exceptional circumstances.
- The *Lasmos* approach provides that where the petition debt is subject to an arbitration agreement, the petition debt is disputed and the debtor takes steps required under the arbitration clause to commence the contractually mandated dispute resolution process, the winding up petition should generally be dismissed save in exceptional circumstances.

The above tests impose a different threshold to that under the traditional or established approach described in the CFA judgment, whereby the debtor needs to demonstrate a bona fide dispute on substantial grounds as to the petition debt for the court to exercise its discretion to stay or dismiss the winding up petition. The *Salford* approach has since been applied in later cases in England including recently *Telnic Ltd v Knipp Medien Und Kommunikation GmbH* [2020] EWHC 2075 (Ch). See our article regarding the *Telnic* case here.

In other common law jurisdictions, different positions have been taken in relation to the applicable standard of review in the context of an insolvency petition where the petition debt is subject to an arbitration agreement. Some jurisdictions have followed or modified the *Salford* approach. In Singapore, for example, the Singapore Court of Appeal adopted the prima facie standard of review in *AnAn Group (Singapore) Pte Ltd v VTB Bank (Public Joint Stock Company)* [2020] SGCA 33, whereby for a winding up petition to be stayed or dismissed, the debtor company must show, on a prima facie basis, that there is a valid arbitration agreement between the parties, the dispute over its indebtedness falls within the scope of the arbitration agreement, and the dispute is genuine. The court will not grant a stay (notwithstanding that the prima facie standard has not been met) if the application for a stay amounts to an abuse of process.

In Hong Kong, the CFA's latest decision refers to but does not resolve the uncertainty surrounding the *Lasmos* approach. The CFA stated: "*It is not necessary for present purposes to explore the interaction of the non-discretionary provision applicable to arbitration clauses with the statutory jurisdiction of the CFI in bankruptcy and in company insolvency.*" However, there may be stronger policy considerations in favour of upholding arbitration clauses as the CFA notes 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 under statute to refer the parties to arbitration upon the request of a party[1].

Appellate consideration of the *Lasmos* approach is left for another day. For the time being, it remains an applicable CFI decision despite the doubts expressed in subsequent cases including *Dayang (HK) Marine Shipping Co Ltd v Asia Master Logistics Ltd* [2020] HKCFI 311, *But Ka Chon v Interactive Brokers LLC* [2019] HKCA 873 and *Re Hong Kong Bai Yuan International Business Co Ltd* [2022] HKCFI 960.

CONCLUSION

This CFA judgment has given certainty to the long-standing question of the effect of EJCs on bankruptcy proceedings. The CA and CFA judgments discussed bankruptcy and winding up proceedings in the same vein and thus it is expected that the same approach will be adopted in winding up proceedings.

The drafting of jurisdiction clauses in contracts is undoubtedly important. As in most cases, the language of the EJC in this case was wide, covering all legal proceedings arising out or relating to the Agreement and was found to cover the bankruptcy petition which was based on a disputed debt.

In agreements involving counterparties with a Hong Kong connection or where there are insolvency concerns, parties should consider the choice of forum(s) when negotiating jurisdiction clauses to avoid drafting away the right to petition the court for bankruptcy or winding up relief. A non-exclusive jurisdiction clause or a hybrid clause providing parties with the option to litigate or arbitrate any disputes would provide greater flexibility than an EJC or an arbitration agreement in any subsequent debt recovery efforts.

In the context of cross border transactions involving Mainland Chinese and Hong Kong parties, the need to adopt EJCs will largely fall away in any case with the upcoming implementation of the Mainland Judgments in Civil and Commercial Matters (Reciprocal Enforcement) Ordinance. See our article regarding the new legislation here.

Should you need advice in drafting and negotiating dispute resolution clauses, please do contact our Litigation & Dispute Resolution team.

[1] Namely, section 20 of the Arbitration Ordinance which requires the court to stay ordinary court proceedings and refer parties to arbitration unless the arbitration agreement in question is null and void, inoperative or incapable of being performed.

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