

HOW MANY WAYS - HONG KONG COURT OF APPEAL GIVES ENCOURAGEMENT TO KEEPWELL CREDITORS



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“The Court of Appeal found the lower court had made a mistake because the judgment had ignored other modes of performance that would not have required relevant approvals”

On 10 May 2024, the Hong Kong Court of Appeal overturned the earlier first instance decision concerning the bonds of Peking University Founder Group (PUFG), finding that PUFG had breached the keepwell obligations it owed to the bond issuers.

PUFG had entered into keepwell agreements with two bond-issuing subsidiaries (Nuoxi Capital Limited and Kunzhi Limited, incorporated in the British Virgin Islands) (the issuers) within the Peking University Group, their two Hong Kong-incorporated direct parents, HongKong JHC Co Limited (HKJHC) and Founder Information (Hong Kong) Limited (FIHK). These companies had guaranteed the issuers' obligations under the bonds (the guarantors) and the bond trustee. The bonds in question were issued in 2017 and 2018, amounting to a total value of approximately US\$1.7 billion. The agreements were governed by English law and the parties submitted to the exclusive jurisdiction of the Hong Kong courts.

In the context of Chinese-funded US dollar-denominated debt, a keepwell agreement usually refers to an agreement between an onshore parent company and its offshore subsidiary, in which the parent company promises to maintain the liquidity and solvency of its offshore subsidiary. It is a structure which has been declining in popularity since January 2017 when the State Administration of Foreign Exchange (SAFE) abolished the limitation on repatriating proceeds raised overseas by mainland companies, which had necessitated the use of foreign subsidiaries and a keepwell structure.

Here, the keepwell deeds contained identical material terms, which required PUFG to cause each of the issuers and guarantors to have sufficient liquidity to ensure timely payment of any amounts payable under the bonds.

The issuers defaulted on their payment obligations, and the guarantors failed to honour the guarantees that were called under the bonds. In addition, Nuoxi, HKJHC, PUFG and the trustee for the bonds also entered into four Deeds of Equity Interest Purchase Undertaking (EIPUs).

The issuers and guarantors (each of which are in liquidation in their respective jurisdictions) sought to submit claims in a Mainland reorganisation process that commenced in 2020 under the Enterprise Bankruptcy Law (EBL). The administrator rejected all of the claims (except one which remains to be adjudicated) without giving reasons. It was only when PUFG filed evidence in support of its application to stay the Hong Kong proceedings that an explanation was provided by the administrator that, as PUFG was insolvent

at the relevant times, regulatory approvals were required to enable the keepwell providers to perform the obligations under the keepwell deeds and the EIPUs.

First instance

On 18 May 2023, judgment was handed down in four actions brought against PUFG. Whilst recognising the binding effect of keepwell deeds, the court dismissed three of the actions brought by Nuoxi, HKJHC and Kunzhi finding that since PUFG was already under a reorganisation process onshore, it was highly unlikely that regulatory approvals to transfer the funds offshore would be forthcoming.

The Court took the view there was a "material difference" between what the company had to show in respect of a failure to comply with the keepwell agreements or the EIPUs before the reorganisation commenced on 19 February 2020 and after it had commenced (a decision on which the authors have written previously).

The Court ruled that PUFG had breached the terms of the keepwell deeds by failing to use its best efforts to secure regulatory approvals to remit funds to FIHK prior to the commencement of reorganisation, thereby causing loss to FIHK in the sum of US\$167 million. Nuoxi, HKJHC and Kunzhi appealed the judgment.

Court of Appeal

While the Court of Appeal rejected several of the grounds of appeal put forward, it agreed with one that related to two clauses within the keepwell deeds, Clause 2.2 and Clause 4(1)(ii).

Clause 2.2 provided *“Notwithstanding anything contained in this Deed, if, and to the extent that the Company is required to obtain necessary approvals (emphasis added), consents, licences, orders, permits and any other authorisations from the relevant Approval Authorities (the Relevant Approvals) in order to comply with its obligations under this Deed, the performance of such obligation shall always be qualified by, and subject to, the Company having obtained such Relevant Approvals. In this regard, the Company undertakes to use its best efforts (emphasis added) to obtain such Relevant Approvals within the time stipulated by the relevant Approval Authorities, if applicable.”*

Clause 4(1)(ii) required PUFG to ensure that Nuoxi and HKJHC had sufficient liquidity to make payments as they fell due.

The Court of Appeal found the lower court had made a mistake because the judgment had ignored other modes

of performance that would not have required relevant approvals including using PUFG's offshore assets, asking a third-party entity not restricted by any PRC law to provide financial support to the plaintiffs, or depositing RMB into a PRC bank account. Such payment methods would not involve payments made from the PRC to offshore entities.

The Court of Appeal considered the judge "should have found on the evidence that issuing new bonds for repaying existing bonds was viable ...and payments made entirely onshore [do] not require Relevant Approvals". Since PUFG had not provided any evidence on how it intended to perform its obligations under the keepwell deeds - and since its suggested mode of performance was one which did require approvals - PUFG was not able to establish that it had used its best efforts to obtain the approvals.

The Court of Appeal found PUFG to be in breach of the terms of the keepwell deeds and ordered declaratory relief in favour of the appellants in the sum of HK\$1.7 billion.

Leave to appeal to CFA

Given the amounts involved, it seemed likely that the decision would be brought to the Court of Final Appeal and indeed on 12 July 2024, the Court of Appeal granted leave to appeal on the question as to whether a breach of an obligation by PUFG to provide liquidity caused actionable loss, despite the fact that by receiving the liquidity the relevant bond issuers would have incurred a corresponding

obligation to repay another creditor in the same amount and their balance sheet position would remain unchanged.

The bondholders' purpose in seeking the declaration was to provide assistance to the Beijing court in order to have the claims admitted in the mainland reorganisation. The extent to which the Court of Appeal decision has any practical effect still remains an open question.

Yet more keepwell disputes

Chinese real estate developers continue to keep the courts busy in Hong Kong. Real estate developer, China South City Holdings Ltd and its keepwell provider, Shenzhen SEZ Construction and Development Group, are currently subject to a Hong Kong High Court action initiated by the bond trustee in respect of keepwell-related breaches under offshore bonds totalling around US\$1.4bn. Assuming this dispute proceeds to a hearing, this may provide an additional opportunity for the Court to grapple with, and provide guidance on, the issues of causation and loss that generally apply to compliance with contractual obligations under such keepwell deeds.

Of course, in any of these keepwell matters, how to achieve successful enforcement or to leverage pressure to achieve returns once a Hong Kong judgment has been obtained remain very much open questions.



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