

MUTUAL RECOGNITION AND ASSISTANCE IN INSOLVENCY PROCEEDINGS BETWEEN MAINLAND CHINA AND HONG KONG

On 14 May 2021, the Hong Kong SAR Government and the PRC Supreme People's Court signed a Record of Meeting setting out a landmark consensus for mutual recognition and assistance of insolvency proceedings between designated Mainland municipalities and Hong Kong.

In conjunction with the Record of Meeting, the PRC Supreme People's Court (SPC) issued a guiding opinion (SPC Opinion) and the Hong Kong SAR Government issued a practical guide, both of which provide further guidance on applications for recognition and assistance in designated Mainland municipalities and Hong Kong respectively.

The SPC Opinion designates Shanghai, Shenzhen, and Xiamen as pilot cities that will recognise and provide assistance to Hong Kong insolvency proceedings. It is anticipated that the framework will be expanded to further Mainland municipalities in the future.

In this briefing, we highlight the key features of this new framework for Hong Kong insolvency proceedings as well as its potential impact on cross-border insolvency proceedings involving both Mainland China and Hong Kong.

KEY FEATURES OF THE NEW FRAMEWORK

In terms of the key features of the new framework as relevant to Hong Kong insolvency proceedings:

1. **Hong Kong insolvency proceedings** - the new framework provides for recognition of collective insolvency proceedings¹ commenced under the Hong Kong *Companies (Winding Up and Miscellaneous Provisions) Ordinance* (CWUMPO) and the *Companies Ordinance* (CO), including compulsory winding up, creditors' voluntary winding up and schemes of arrangement under the CO promoted by a liquidator or provisional liquidator and sanctioned by a Hong Kong court.

¹ A "collective insolvency proceeding" is defined as "a process of collective enforcement of debts for the benefit of the general body of creditors", as opposed to a solvent proceeding such as the members' voluntary liquidation. See Harris J in *Re Supreme Tycoon Ltd (in liquidation)* [2018] 2 HKC 485, para. 15 citing Brightman LJ in *Re Lines Bros Ltd* [1983] Ch 1 (CA), para. 20.

Key issues

- The new framework designates three pilot areas in Mainland China, i.e. Shanghai, Shenzhen, Xiamen to offer mutual recognition and assistance of insolvency proceedings with Hong Kong.
- The new framework sets out detailed guidance and procedures on how PRC courts will recognise and assist in Hong Kong insolvency proceedings.
- The new framework is very much a first step and is designed to deal with insolvency processes commenced under Hong Kong law. In practice, many companies in distress in the Hong Kong market are incorporated in other offshore jurisdictions, and often insolvency proceedings are commenced in their jurisdiction of incorporation, with recognition being sought in Hong Kong. The new framework does not extend to these proceedings.
- We anticipate that with time and experience, the framework will be further developed and potentially expand to enable more widespread use.

2. **Hong Kong COMI** – in addition to being subject to a Hong Kong insolvency proceeding, the debtor must have its centre of main interests (COMI) in Hong Kong for at least six consecutive months prior to the application. COMI will generally be taken to be the debtor's place of incorporation, but other factors such as the debtor's principal office and places of business and assets will be considered as well.
3. **Business or assets in a pilot area** - the debtor must have principal assets, place of business or a representative office in a pilot area.
4. **Consequences of recognition in Mainland China** – if the Hong Kong insolvency proceeding is recognised by the PRC court, (i) payments to individual creditors by the debtor thereafter are invalid; and (ii) legal proceedings in Mainland China will be generally suspended until the Hong Kong insolvency officeholder has assumed control over the debtor's property. The SPC may also grant a wide range of reliefs to the Hong Kong insolvency officeholder, including allowing the officeholder to take over the debtors' assets, books and records, managing the debtor's business and affairs, and conducting investigations.
5. **Availability of interim relief in Mainland China** - the PRC court may grant interim relief pursuant to PRC law upon the Hong Kong insolvency officeholder's application during the interval between the PRC court's receipt of the application for recognition and assistance and its rendering of the decision.

ASSISTANCE BY THE PRC COURTS

Upon recognition, the relevant PRC court may provide assistance to the Hong Kong insolvency proceeding in either of the following ways:

1. to allow the Hong Kong insolvency officeholder to perform the duties within the scope of *both* the *PRC Enterprise Bankruptcy Law* and the applicable Hong Kong laws (such as taking over, managing and disposing of the debtor's assets, and participating in onshore legal actions on behalf of the debtor), with actions having a major impact on creditors' interest (such as the creation of encumbrances on the debtor's assets and transfer of assets offshore) to be specifically approved by the PRC court; or
2. to designate, upon the application by the relevant Hong Kong insolvency officeholder or a creditor, a Mainland administrator to perform the above duties, and the *PRC Enterprise Bankruptcy Law* shall apply to the debtor's onshore affairs and assets.

The option of designating a Mainland administrator is intended to be a practical innovation to enhance efficiency of the Hong Kong insolvency officeholder's discharge of their duties in Mainland China, as the former is likely to be better positioned to coordinate with various stakeholders there, including PRC government authorities (e.g. market supervision authority and tax authority). The mechanics through which the Mainland administrator is selected for appointment are currently unclear, but a process which allows the appointment of a Mainland administrator affiliated to the Hong Kong insolvency officeholder is likely to be efficient for the administration of the insolvency process.

It is also worth noting the grounds for where the PRC courts may decline to recognise the Hong Kong insolvency proceeding as set out under the SPC Opinion, which include:

1. Upon objection by an interested party, the PRC court finds that one of the following circumstances exists:
 - (a) the debtor's COMI is not or has not been situated in Hong Kong for at least six consecutive months prior to the application;
 - (b) the debtor has not satisfied Article 2 of the *PRC Enterprise Bankruptcy Law*²;
 - (c) Mainland creditors are unfairly treated;
 - (d) there is fraud; or
 - (e) there are other circumstances where the PRC court considers that recognition or assistance shall not be rendered.
2. On its own initiative, the PRC court considers the recognition or assistance violates the PRC basic principles of law or offends the public order or good morals.

Some of the above grounds may have been intentionally phrased broadly in order to allow flexibility for the PRC courts to navigate this new framework. It is expected that the PRC courts will be highly cautious in exercising the power to reject recognition and assistance similar to that in the recognition and enforcement of Hong Kong (and foreign) arbitral awards and qualified judgments.

We anticipate that the framework will be further developed based on the practical circumstances arising from real life cases, and it is hoped that the scope of the framework will eventually be broadened to enable widespread application.

IMPLICATIONS FOR CREDITORS IN HONG KONG

The arrangement set out in the SPC Opinion is a development long-awaited by the Hong Kong restructuring and insolvency market, and is a critical first step in resolving a number of historical issues faced by offshore insolvency practitioners in obtaining access to and control over information and assets onshore. The adoption of the concept of COMI, in particular, is broadly in line with international cross-border recognition regimes and should be applauded (although it is noted that the six month qualification period is longer than COMI regimes in other jurisdictions).

² Article 2 of the *PRC Enterprise Bankruptcy Law* provides, "Where an enterprise legal person fails to pay off its debts as they become due, and if its assets are not sufficient to pay off all the debts or if it is obviously incapable of paying off its debts, its liabilities shall be liquidated according to the provisions of this Law. Where an enterprise legal person is under the circumstances as specified in the preceding paragraph or it has apparently lost the ability to pay off its debts, it may undergo reorganization according to the provisions of this Law."

That said, Hong Kong creditors and officeholders should be aware that the new framework is by no means a "cure-all", and will need to be conscious of the limitations they face under the new framework:

1. In practice, many companies in financial difficulty in Hong Kong are incorporated in offshore jurisdictions such as Bermuda, the Cayman Islands and the British Virgin Islands. In recent years, it has become increasingly common for insolvency proceedings to be commenced in the offshore jurisdiction of incorporation (including by the appointment of "light touch" provisional liquidators who work alongside the company's management to facilitate a restructuring), with recognition subsequently sought in Hong Kong under common law. However, the new framework only applies to debtors who satisfy two separate criteria: (i) it is subject to a Hong Kong insolvency proceeding, and (ii) its COMI is located in Hong Kong for at least six consecutive months prior to the application. In other words, insolvency officeholders of these offshore companies appointed under the laws of the jurisdiction of incorporation will not benefit from recognition in Mainland China under the new framework.
2. It is relatively uncommon for a company subject to a Hong Kong insolvency proceeding to hold onshore assets directly; it is more likely to hold the onshore assets through a WFOE. The extent to which a PRC court is prepared to recognise and grant assistance to the Hong Kong insolvency officeholder as controllers of the offshore shareholding entity and facilitate the change of directors and the legal representative of the WFOE without the cooperation of former management of the WFOE remains to be tested.
3. To the extent that Hong Kong creditors find themselves in a disadvantaged position to onshore creditors as a result of issues arising from their lending structure (such as structural subordination and lack of direct recourse to asset-holding companies onshore), the new framework is not designed to improve their position. In other words, Hong Kong creditors should continue to give careful consideration to structural issues when lending to companies with substantial business and assets onshore.

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