ALLEN & OVERY

Bankruptcy Petition vs Exclusive Jurisdiction Clause

Who has the last word? The effect of an exclusive jurisdiction clause on insolvency proceedings

On 4 May 2023, the Court of Final Appeal (**CFA**) handed down its much-awaited judgment in Re Guy Kwok Hung Lam [2023] HKCFA 9. This decision is significant. It clarifies the proper approach in deciding whether to dismiss or stay a creditor's bankruptcy petition before Hong Kong courts, where the underlying petition debt arises from an agreement containing an exclusive jurisdiction clause (**EJC**) in favour of a foreign court. In this article, our insolvency, litigation and arbitration specialists consider the practical implications of this decision.

Background

What are the facts?

This case concerns a bankruptcy petition brought by a fund creditor (the **Creditor**) against Guy Kwok Hung Lam (the **Debtor**). In 2017, pursuant to a Credit and Guaranty Agreement (**Credit Agreement**), the Creditor advanced a USD9.5m loan to a company founded and controlled by the Debtor, who agreed to guarantee the payment of the amounts due and owed by his company. The Credit Agreement contains an EJC, whereby the parties submitted to the exclusive jurisdiction of the New York court.

Following the non-payment of the loan, the Creditor served a statutory demand on the Debtor and, when the demand was not met, brought a bankruptcy petition against the Debtor in Hong Kong in 2020. The Debtor opposed the petition, claiming (among other things) that the debt is disputed, relying on proceedings commenced in New York in which he sought a declaration that there had been no event of default under the Credit Agreement, and because of the EJC, the Creditor is required to litigate the dispute in the New York courts before coming to Hong Kong to invoke the bankruptcy regime.

What was at issue in this case, and what was the decision?

The key issue in the proceedings concerns the approach of the Hong Kong court to a bankruptcy petition where the underlying dispute about the petition debt is the subject of an EJC.

The Hong Kong Court of First Instance made a bankruptcy order against the Debtor[1], on the basis that he had failed to show that there was a **bona fide** dispute on substantial grounds in respect of the debt. The Court of Appeal (**CA**) allowed the Debtor's appeal and dismissed the petition[2]. The majority in the CA concluded that if the dispute about the debt fell within the scope of an EJC, the bankruptcy petition should not be allowed to proceed without strong reasons.

On appeal, the CFA upheld the CA's majority views. The bankruptcy petition therefore could not proceed.

What was the CFA's approach in deciding whether to dismiss or stay the bankruptcy petition?

The CFA noted that the determination of whether a petition debt is subject to a **bona fide** dispute on substantial grounds is an element of the jurisdiction conferred on the court in bankruptcy proceedings. However, this is a "**threshold question**". This means that the court retains a discretion to decline to exercise its jurisdiction to determine this threshold question, ie despite having jurisdiction to do so, the court may decide to refrain from determining whether the petition debt is **bona fide** disputed on substantial grounds. A circumstance enlivening that discretion is the fact that the parties agreed to have all their disputes under the agreement giving rise to the debt be determined exclusively in another forum.

In exercising this discretion, the court recognises there are competing public policies.

1 [2021] HKCFI 2135.
2 [2022] 4 HKLRD 793; [2022] HKCA 1297.

– On the one hand, there is public policy interest in upholding the parties' contractual bargain, ie in agreeing to have all their disputes under the agreement giving rise to the debt determined exclusively in another forum in accordance with an EJC.

– On the other hand, the court recognises the public policy underpinning the legislative scheme of the court's bankruptcy jurisdiction, eg the public interest in having an orderly system that is fair to all creditors, preventing continued trading by an insolvent trader, policing commercial morality.

The more obviously insubstantial the grounds for disputing the debt, the more this policy comes into prominence. However, the significance of these public policy considerations is much diminished where the petition is brought by one creditor against another and there is no evidence of a creditor community at risk.

The CFA concluded that the "Established Approach", namely that a petitioner will ordinarily be entitled to a bankruptcy order (or in the case of corporate insolvency, a winding up order) if the petition debt is not subject to a **bona fide** dispute on substantial grounds, was not appropriate where an EJC is involved. In the ordinary case of an EJC, absent countervailing factors such as the risk of insolvency affecting third parties and a dispute that borders on the frivolous or abuse of process, the parties ought to be held to their contract. It was for the New York court to determine whether the petition debt was **bona fide** disputed.

The court dismissed the appeal and upheld the CA's decision in dismissing the bankruptcy petition[3].

Implications of the CFA decision for creditors

Our insolvency, litigation and arbitration specialists share their views on six questions which creditors may have in light of the CFA decision.

1. **If a loan agreement contains an EJC in favour of a foreign court, how does this judgment affect a creditor's debt recovery approach if a debtor defaults?**

   The creditor should carefully weigh the cost and benefit of issuing statutory demand or petitioning for bankruptcy or winding up as compared to taking legal action in the foreign court. The insolvency route should only be pursued after the creditor has fully considered all of the factors mentioned below to avoid nasty surprises.

2. **What are some factors which would likely persuade the court to grant a bankruptcy or winding up order notwithstanding the existence of an EJC in favour of a foreign court?**

   The CFA and the CA provided hints of some factors which the court may find persuasive:

   – There are other creditors pursuing the debtor or presenting a petition;

   – The debtor is "*incontestably and massively insolvent*" quite apart from the disputed petition debt – a factor probably more relevant to companies' winding-up than personal bankruptcy;

   – The fact that the debtor's arguments in disputing the debt are weak would likely be insufficient, but the court may be persuaded if the debtor's defence is "*completely frivolous*" or borders on "*abuse of process*". In other words, when considering the debtor's arguments the court would assume that facts alleged in the debtor's defence are true;

   – The debtor may, for some other reasons, be a "*menace to commercial society if allowed to continue to trade*".

3. **This judgment is concerned with an EJC in favour of the New York court. Would the Hong Kong court's approach be different if the loan agreement contains an EJC in favour of the Hong Kong courts?**

   If the EJC is in favour of the Hong Kong courts, then the matter is simpler as there will not be any tension regarding the parties' contractual bargain over the agreed dispute resolution forum. However, if the petitioned debt is disputed on substantial grounds, the Hong Kong court may still decide to set aside a statutory demand (for personal bankruptcy), or injunct a winding-up petition from being presented, or dismiss or stay all bankruptcy or winding-up proceedings for such time as may be required for trial of the question relating to the debt.

4. **What about arbitration clauses? Would the approach be different if the loan agreement contains an arbitration clause?**

   The case law in Hong Kong in relation to the tension between arbitration and the court's insolvency regime remains unsettled. However, many of the public policy considerations identified in the CFA judgment with respect to an EJC would be equally relevant in the case of an arbitration clause, including the public policy interest in upholding the parties' contractual bargain in having their disputes determined exclusively in their agreed forum.

3 The CFA did not consider whether the EJC required bankruptcy proceedings undertaken by the Creditor against the Debtor to be instituted in New York. The CFA expressly noted that proposition had not been advanced.

Therefore, for practical purposes, if a disputed petition debt is subject to an arbitration clause, then similar to the case of an EJC, creditors should be alive to the possibility that the Hong Kong court may stay or dismiss a bankruptcy or winding-up petition on the basis that the dispute should be heard before the parties' agreed forum. As with the case of an EJC, creditors should carefully weigh the cost and benefit of issuing statutory demand or petitioning for bankruptcy or winding up as compared to pursuing an arbitration.

5. **Is there anything that creditors should think about to improve their position on debt recovery at the drafting and negotiating stage?**

- Having a good understanding of the credit structure of the debtor at the outset to identify effective levers in case of default.
- When choosing the jurisdiction to specify in an EJC, consider one aligned with the jurisdiction where a bankruptcy or insolvency petition against a given obligor will likely be brought.
- Negotiating a good security package is always of paramount importance. Recovery via security enforcement is typically more cost-effective and efficient. Then choose carefully the governing law and dispute resolution clause for that security.
- Consider the amount of time required to resolve the dispute in the designated forum, in case the debt is disputed.
  - **EJC**: consider whether summary judgment or similar procedures are available in the designated jurisdiction, and how long it takes to obtain a binding ruling.
  - **Arbitration clause**: consider including wording to provide for agreement to expedited procedures.
- Consider including hybrid dispute resolution clauses, for example, asymmetrical jurisdiction clauses giving the lender a right to sue anywhere whilst limiting where the borrower can sue, or an arbitration clause with an option to litigate. However, these should be carefully drafted and parties should seek advice as to whether they would pose issues in the jurisdictions where enforcement will likely be sought.

6. **Is there anything that creditors can do to improve their position on debt recovery at the disputes stage?**

- If the creditor is concerned about dissipation of assets by the debtor, consider applying for interim measures, eg asset-freezing injunction in aid of foreign proceedings or arbitration proceedings.
- In the case of arbitration, even if the parties have not agreed upfront to an expedited procedure in their arbitration clause, many arbitral institutional rules still include mechanisms for a party to apply for early determination or expedited procedure, which may help fast track the proceedings.

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