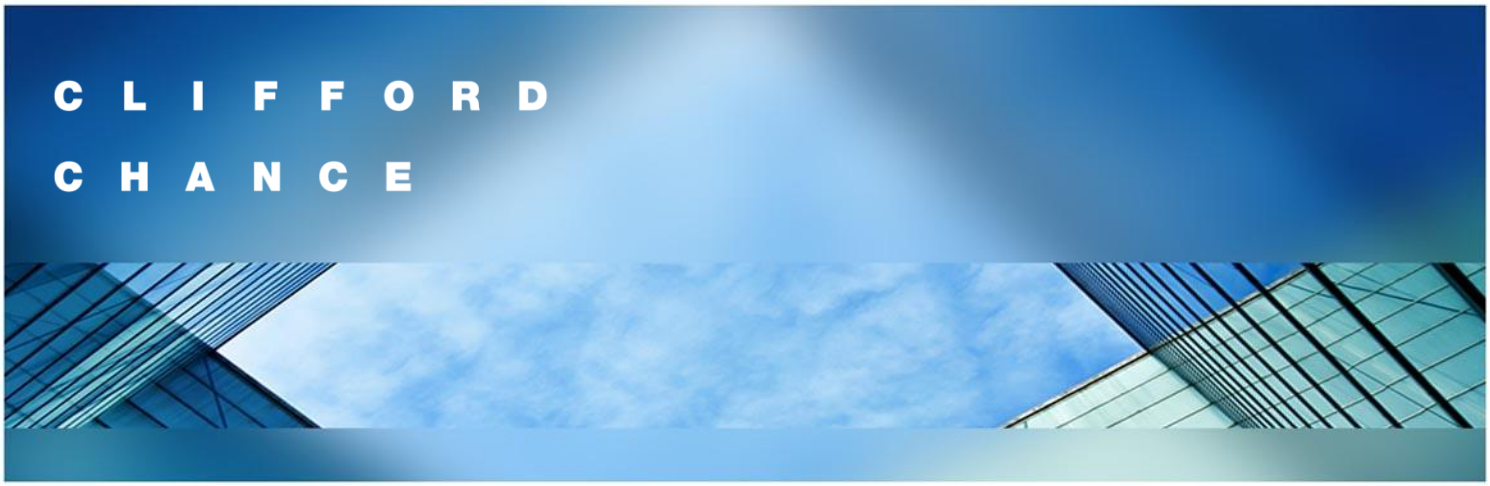

HONG KONG COURT OF APPEAL LAYS DOWN THE TEST FOR INSOLVENCY PETITIONS WHERE THERE IS AN ARBITRATION AGREEMENT CONFIRMING APPLICABILITY OF RE GUY LAM

The Court of Appeal ("**CA**") handed down two landmark decisions on the same day, confirming that the court will give effect to arbitration agreements covering debts and cross-claims in the context of winding up and bankruptcy petitions (collectively, **"insolvency petitions"**).

The CA's ruling echoes the strong public policy requiring parties to abide by their contracts, in particular, the parties' agreement on the dispute resolution mechanism. In situations where the underlying dispute surrounding the petition debt or a cross-claim is subject to an arbitration agreement, the court will not hesitate to dismiss an insolvency petition and have the dispute determined by way of arbitration save in wholly exceptional circumstances.

Key issues

- Where the underlying dispute surrounding the petition debt is subject to an arbitration clause, the Hong Kong court will decline insolvency jurisdiction, unless there are "strong reasons" and "countervailing factors" which lead to the exercise of discretion not to decline jurisdiction.
- The court must be satisfied that there is a genuine intention to arbitrate the dispute, so as to hold the parties to their agreed dispute resolution mechanism. This is to deter a debtor from merely raising an arbitration clause as a tactical move to stave off winding up or bankruptcy.
- The same principles apply equally to cases where the debt is not disputed but a cross-claim is raised which exceeds the debt owed.
- In cases where the "strong reasons" include "a dispute that borders on the frivolous or abuse of process", questions arise as to how this differs in practice to the requirement of a "bona fide dispute" under the traditional test for insolvency petitions.

INTRODUCTION

There has long been a tension between parties' contractual right to resolve their dispute in accordance with their chosen dispute resolution method, and the statutory right to petition for winding up or bankruptcy. In the judgment of *Re Guy Kwok-Hung Lam* [2023] HKCFAR 119 (***"Re Guy Lam"***), 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 surrounding the petition debt is subject to an exclusive jurisdiction clause in favour of a foreign court, the Hong Kong court should stay or dismiss the insolvency proceedings before it unless there are strong reasons to the contrary. See our briefing regarding *Re Guy Lam* here.

Since the judgment of *Re Guy Lam*, there have been numerous cases discussing whether the same approach also applies to arbitration clauses. In the two judgements of *Re Simplicity & Vogue Retailing (HK) Co., Limited* [2024] HKCA 299 and *Arjowiggins HKK 2 Limited v Shandong Chenming Paper Holdings Limited* [2024] HKCA 352, the CA provides much-welcomed clarity by confirming that the approach laid down in *Re Guy Lam* applies by

analogy where the dispute over the petition debt or surrounding a cross-claim is subject to an arbitration clause.

Essentially, what this means is that in the absence of "countervailing factors" giving rise to "wholly exceptional circumstances" or "strong reasons", the Hong Kong court should decline insolvency jurisdiction where the underlying dispute surrounding the petition debt or a cross-claim is subject to an arbitration clause.

The position in Singapore and England & Wales is comparable with the caveat that the key decisions in England & Wales leave open the applicability of the test when it comes to cross-claims (see table at the end of this briefing). Parties should bear this and any other difference in relevant jurisdictions in mind when entering into arbitration agreements.

COURT WILL GIVE EFFECT TO ARBITRATION AGREEMENTS

In *Re Simplicity & Vogue Retailing (HK) Co., Limited* [2024] HKCA 299, the CA extended the approach in *Re Guy Lam* to situations involving arbitration clauses.

Background

The petitioner, China Everbright Securities Value Fund SPC, subscribed to convertible bonds issued by the issuer, Simplicity & Vogue Retailing Corporation. By way of a corporate guarantee provided by the company, Simplicity & Vogue Retailing (HK) Co., Limited, the company guaranteed the obligations of the issuer to the petitioner under the bond instrument. Both the bond instrument and the corporate guarantee contained a provision for arbitration.

Subsequently, the issuer defaulted on its payment obligation under the bond instrument. The petitioner enforced the corporate guarantee and demanded that the company pay the amount due and payable to the petitioner. As the company failed to make payment, the petitioner presented the winding up petition in December 2022.

Before the Court of First Instance, one of the arguments raised by the company was that the winding up order should not be granted as the bond instrument and the corporate guarantee both contained an arbitration clause, and hence, the dispute over the petitioning debt should be referred to arbitration. In deciding this issue, Justice Linda Chan took the view that (i) the approach laid down in *Re Guy Lam* only applies to cases involving an exclusive jurisdiction clause, and not to cases involving an arbitration clause, and (ii) there is no proper basis to require the parties to refer their dispute to arbitration in the absence of any genuine dispute in respect of the debt.[1] Accordingly, Justice Linda Chan granted a winding up order against the company.

[1] On the facts, the company disputed the debt on the basis that the corporate guarantee had been discharged by reason of variation of the principal contract between the petitioner and the issuer. This argument was found to be wholly without merit as the guarantee expressly provided that there shall be no discharge by reason of variation.

CA's Decision

On appeal, the key issue for the CA's determination was whether the court should decline jurisdiction in an insolvency petition where the underlying dispute surrounding the petition debt is the subject of an arbitration agreement.

In deciding this issue, the CA held that the principles for the appropriate exercise of the court's discretion to decline the exercise of insolvency jurisdiction as set out in *Re Guy Lam* apply equally to arbitration clauses. In fact, the CA stated that having regard to the statutory framework protective of arbitration, there is an even stronger case for upholding the parties' contractual bargain that disputes falling within the scope of an arbitration clause should be resolved by arbitration.

The CA also effectively endorsed the approach in *Re Southwest Pacific Bauxite (HK) Limited* [2018] 2 HKLRD 449 (***"Lasmos"***). In considering whether the third requirement in *Lasmos* applies (i.e. that the debtor should actively pursue arbitration), the CA held that the court must be satisfied of a genuine intention to arbitrate, so as to hold the parties to their agreed dispute resolution mechanism. This is to deter a debtor from merely raising an arbitration clause as a tactical move to stave off winding up. The CA also clarified that if no steps had been taken to commence arbitration, the court could still exercise its discretion in an appropriate case to grant a short adjournment for the debtor to commence arbitration and require an undertaking from the debtor to proceed with the arbitration with all due dispatch.

This said, while the court will generally uphold arbitration clauses, the court should take a "multi-factorial" approach and still retains flexibility to deal with the case as the circumstances require. This means that the court may exercise its discretion not to decline insolvency jurisdiction in exceptional situations, such as where there is a creditor community at risk; a danger of insolvency affecting third parties; and/or if the dispute is insubstantial, bordering on the frivolous or amounts to an abuse of process.

On the facts, the CA dismissed the company's appeal on the basis that there was no evidence to indicate that the petition debt was disputed and that the dispute would be referred to arbitration. Further, the defence raised by the company was one that "*borders on the frivolous or abuse of process*" and was a sufficient "countervailing factor" leading to the exercise of discretion not to decline jurisdiction in the winding up petition.

SAME APPROACH APPLIES TO SITUATIONS INVOLVING CROSS-CLAIMS

In the second judgment handed down by the CA in *Arjowiggins HKK 2 Limited v Shandong Chenming Paper Holdings Limited* [2024] HKCA 352, the CA affirmed the decision of Harris J in the Court of First Instance and clarified that the principles in *Re Guy Lam* apply to situations involving cross-claims, just as they do in cases where the debt is disputed.

Background

In this case, the petitioner, Arjowiggins HKK 2 Ltd, and the company, Shandong Chenming Paper Holdings Limited, entered into an agreement in October 2005, pursuant to which they established a joint venture company in the Mainland. The joint venture agreement contains an arbitration clause which states that any dispute arising out of or in connection with the joint venture agreement is to be referred to arbitration.

Disputes arose between the parties and the parties became embroiled in a series of litigation and arbitration proceedings. This eventually culminated in the petitioner presenting a winding up petition against the company in June 2017. On 20 June 2022, the company commenced arbitration proceedings against the petitioner, for breach of the joint venture agreement and its duties as controlling shareholder under PRC law. On this basis, the company claimed that it had a cross-claim against the petitioner in an amount exceeding the remainder of the petition debt and that the petition should be dismissed or adjourned pending the arbitration proceedings.

While the parties in this case did not dispute that the approach in *Re Guy Lam* applies by analogy where the dispute over the petition debt is subject to an arbitration clause, the petitioner argued that this approach is inapplicable where the debtor relies on a cross-claim subject to an arbitration clause. In the Court of First Instance, Harris J rejected the petitioner's argument and found that as a general principle of insolvency law, there is no distinction between the approach to disputed debts and cross-claims. Likewise, when considering the impact of an arbitration clause, no distinction should be drawn between them.

CA's Decision

In dismissing the appeal filed by the petitioner, the CA held that in exercising its bankruptcy or winding-up jurisdiction, the court does not wear blinkers and look only at the petition debt. Instead, the court will have regard to the entire relationship between the parties and will regard a debtor's cross-claim against the petitioner as a practical equivalent to disputes of the debt. Further, the CA held that when the cross-claim is subject to an arbitration clause, the court will not enter into an analysis of its merits and determine whether there is a genuine and serious cross-claim. To do so would go against the parties' agreement. This goes back to the public policy for holding parties to their contractual agreement.

The CA specifically agreed with the proposition set out in the Singapore Court of Appeal decision of *AnAn Group (Singapore) Pte Ltd v VTB Bank (Public Joint Stock Company)* [2020] SGCA 33, which states that the tests for both disputed debts and cross-claims must necessarily mirror each other, and that in both cases, winding up proceedings will be stayed or dismissed where the dispute falls within a valid arbitration agreement between the parties, provided the dispute is not being raised in abuse of the court's process.

CONCLUSION

The two CA judgments have laid to rest the controversy and debate arising from first instance decisions surrounding the question of whether the approach in *Re Guy Lam* applies to situations involving an arbitration clause.

Parties to intended or pending insolvency proceedings should always consider whether there is any potential dispute over the debt giving rise to the petition. Where there is a dispute or potential dispute which is subject to an arbitration agreement, questions will arise as to whether the dispute is frivolous or an abuse of process, and furthermore how this element of the test laid down by the CA differs in practice to the *bona fide* dispute requirement under the traditional test for insolvency petitions.

Following the CA's ruling, in the case of disputes that are not frivolous, parties who have agreed to refer their disputes to arbitration should proceed with arbitration to resolve any issues before commencing insolvency proceedings, so as to avoid incurring wasted time and costs in insolvency proceedings only for the insolvency petition to be stayed or dismissed because of a dispute over the debt which should properly be resolved by way of arbitration.

Dispute resolution clauses are important and can have far reaching implications. In adopting an appropriate dispute resolution clause in the underlying agreement between the parties, factors to consider include whether they wish to preserve the right to invoke the court's insolvency jurisdiction in situations of default of debt, and whether it might be appropriate to adopt consistent dispute resolution clauses in transactions involving a series of contracts to avoid potential complications in the event of any cross-claims.

SUMMARY OF THE EFFECT OF ARBITRATION CLAUSES ON INSOLVENCY PETITIONS IN MAJOR COMMON LAW JURISDICTIONS

	Hong Kong	**Singapore**	**England & Wales**
Leading case authority	***Re* Simplicity & Vogue Retailing (HK) Co., Limited** [2024] HKCA 299 ***Arjowiggins HKK 2 Limited v Shandong Chenming Paper Holdings Limited*** [2024] HKCA 352	***AnAn Group (Singapore) Pte Ltd v VTB Bank (Public Joint Stock Company)*** 1 SLR 1158 ***BWG v BWF*** 1 SLR 1296	***Salford Estates (No.2) Ltd v Altomart Ltd* [2014] EWCA Civ 1575** ***Telnic Ltd v Knipp Medien Und Kommunikation GmbH*** [2020] EWHC 2075 (Ch)
Approach adopted by each jurisdiction	Where the underlying dispute surrounding the petition debt is subject to an arbitration clause, the Hong Kong court will decline insolvency jurisdiction. However, where there are "countervailing factors" giving rise to "wholly exceptional circumstances", the court might exercise discretion not to decline insolvency jurisdiction. Such factors include situations where the dispute over the debt borders on the frivolous or abuse of process. The court must also be satisfied of the genuine intention to arbitrate, so as to hold the parties to their agreed dispute resolution mechanism. This is to deter a debtor from merely raising an arbitration clause as a tactical move to stave off winding up or bankruptcy.	Applies a prima facie standard of review. The debtor company must show, on a prima facie basis, that (i) there is a valid arbitration agreement between the parties, (ii) the dispute over its indebtedness falls within the scope of the arbitration agreement, and (iii) the dispute is genuine before the Singapore court will stay or dismiss the winding up petition. 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.	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.
Applies to cross-claims?	Yes	Yes	Uncertain

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