Restructuring in provisional liquidation: In the Matter of Sun Cheong Creative Development Holdings Limited

As Covid-induced insolvencies and restructurings gather pace, in *Sun Cheong Creative Development Holdings Limited* the Grand Court of the Cayman Islands (the "**Grand Court**") has provided a timely overview of the principles of comity and modified universalism applicable in cross border restructurings.

Background

Sun Cheong Creative Development Holding Limited (the "**Company**") is incorporated in the Cayman Islands, registered in Hong Kong and its shares are listed on the Hong Kong Stock Exchange. It is the holding company of a group which manufactures and sells a range of plastic household products. The Company conducted the majority of its business outside of Hong Kong, with manufacturing occurring in mainland China.

While the Company had historically been profitable and had the capacity to generate significant revenue, it was facing financial difficulties owing to a confluence of events in 2019 and 2020, including the US/China trade war, the loss of the Company's founder and the disruption occasioned by the Covid-19 pandemic. The Company was indebted to 11 different bank creditors in the aggregate sum of HK$168 million and it was accepted that the Company had insufficient assets to satisfy these debts when they fell due. Several banks had commenced recovery action in Hong Kong, and two winding up petitions were also presented to the Hong Kong Court.

With the looming threat of a winding up order being made in Hong Kong, the Company urgently petitioned the Grand Court for its own winding up on 27 July 2020, and at the same time applied for the adjournment of the petition hearing and the appointment of joint provisional liquidators from FTI (the "**JPLs**"), to pursue a restructuring of the Company's liabilities under the supervision of the Grand Court. The Company's request for the appointment of JPLs was presented on the basis that, *inter alia*, (i) the Company had a "white knight" investor prepared to inject HK$75 million into the Company to facilitate a restructuring, (ii) the board of directors had undergone wholesale changes, and (iii) independent reporting identified that official liquidation would be catastrophic for creditors, seeing returns of only 1 cent on the dollar.

Locus of the primary insolvency proceeding

Before considering the request for the appointment of provisional liquidators, and in circumstances where two petitions had already been presented in Hong Kong, the starting point for the Grand Court was to consider which jurisdiction was the most appropriate to assume the role of primary insolvency proceeding. The Chief Justice observed at paragraph [6] of his Judgment:

"…All other things being equal, this will generally be assumed to be the place of incorporation of the company, being the place that its investors, service providers and trade creditors would typically associate with, among other things, the company's registered office and the law governing the duties of its board of directors and its Articles of Association."

The Grand Court recognised that there are, however, occasions where a Cayman-domiciled company might be subject to primary insolvency proceedings in a foreign court. Such circumstances are typically limited to where:

1. there is a sufficiently strong nexus between the Company and the foreign jurisdiction so as to shift the legitimate expectation of interested parties as to the locus of the primary insolvency proceedings;
2. the foreign court has appointed insolvency practitioners to effect a restructuring (although the Grand Court will not defer automatically to those proceedings presented first in time, and will consider the merits of the proposed reorganisation); and
3. no competing proceedings were initiated in the Cayman Islands.

The Chief Justice agreed with the Company that Cayman was the most appropriate jurisdiction, notwithstanding the impact on the Hong Kong proceedings (the parties to which could be heard upon the return date of the Company's summons in Cayman). The Grand Court was satisfied that representatives from FTI's Hong Kong and Cayman offices should be appointed to safeguard the Company's assets for the benefit of the Company's creditors, and to develop and present a scheme of arrangement.

Restructuring debt in provisional liquidation

Section 104(3) of the Companies Act (2020 Revision) (the "**Act**") provides a company with the power to apply *ex parte* (after the presentation of a winding up petition) for the appointment of a provisional liquidator on the grounds that (a) the company is or is likely to become insolvent, and (b) the company intends to present a compromise or arrangement to its creditors. As to the first limb, which in this case was satisfied by the Company's acknowledgement that it was cash-flow insolvent, the Chief Justice observed (citing his recent judgment *In Re OneTradex Ltd*[1]) that it would be unjust to impose a soft-touch restructuring provisional liquidation on creditors where a company was in fact able to pay its debts, and the provisional liquidation was for the purposes of allowing the company to improve or expand its business.

In relation to the second limb, the Grand Court also acknowledged the broadly accepted position in the Cayman Islands that an intention by the Company to present a compromise or arrangement under s104(3) can justify a departure from the normal principle that a creditor with an undisputed debt is entitled to a winding up order '*ex debito justiciae*' (as of right). The rationale in such circumstances is to provide "*breathing space*" and to preclude creditors from frustrating a consensual restructuring or scheme of arrangement by acting in their self-interest.[2]

The authorities reviewed by the Chief Justice confirm the Grand Court has a *very wide* discretion under s104(3) which it ought to exercise having regard to (i) whether the restructuring is likely to be more beneficial to creditors than a winding up order, (ii) the views of creditors, and (iii) the considered views of the company's board as to the most appropriate way forward.

The restructuring proposal, notably involving the injection of HK$75 million into the Company (of which HK$60 million was intended to settle liabilities via a scheme of arrangement under section 86 of the Act), provided a clear upside to creditors in circumstances where (i) very few assets would have been available (or realisable) in an official liquidation and (ii) the restructuring could realistically achieve 30{92e447aa5ae4509d19f58c4a2ed7ec0dbb286610ae15b33d823e9409689b2d4a} recoveries for creditors whilst also promoting the long-term viability of the Company by financing new sources of revenue. The Grand Court therefore accepted (with the benefit of independent reporting by FTI) that the appointment of JPLs to promote a restructuring was in the best interests of the Company's stakeholders.

Comity and modified universalism

In the context of competing petitions in Hong Kong (which could have drastically limited the options available to the Company), and where various creditors had either supported the Company's summons or engaged with FTI in relation to the development of their restructuring proposal, the Chief Justice weighed the principles of comity and modified universalism which promote the collective protection of all stakeholders' interests (whether domestic or foreign) through the orderly administration of the Company's affairs on a global basis.

The Chief Justice conducted a helpful review of the authorities before considering those factors to be weighed by the Court, namely:

1. the difficulties which could arise in promoting a scheme of arrangement under s 86 of the Act if a winding up order was first made in Hong Kong;
2. the need to avoid duplicative work and additional costs arising from parallel proceedings;
3. the breadth of powers available to the insolvency practitioners in each jurisdiction, and the lack of any settled soft touch provisional liquidation regime in Hong Kong[3] compared with the Cayman process which would allow the promulgation of a scheme of arrangement under the supervision of the Grand Court;
4. the nature of relief sought in the foreign jurisdiction; and
5. the locus of the company's business.

The Chief Justice observed, in summary:

"*Where the purpose has been to facilitate a restructuring or otherwise avoid the need to wind up the company, the cases show that the Court will be more willing to grant recognition as being in the best interests of the company's stakeholders. Conversely, the Grand Court will be slow to give primacy to pure winding-up proceedings brought overseas in respect of a Cayman Islands company where it is satisfied that there is an intention on the part of the company to present a plan of reorganisation for the benefit of its creditors.*"

Conclusion

With financial distress on the rise globally, *Sun Cheong Creative Development Holdings Limited* provides a timely guide to the Grand Court's approach to cross border debt restructurings.

For Campbells' advisory on restructuring debt in the Cayman Islands, click here.

[1] *In Re OneTradex Ltd (in provisional liquidation)* FSD 166 of 2019 (Unreported, 1 October 2020)
[2] See *CW Group Holdings Limited* (unreported, 3 August 2018)
[3] See *In Changgang Dunxin Enterprise Company Limited* (Unreported, 1 March 2018) for a further discussion by Mangatal J on the restructuring powers available to JPLs in Cayman and Hong Kong, and the recent decision of the Hong Kong Court of First Instance in *Re China Solar* [2018] HKCFI 555 which indicates that a soft touch provisional liquidation may in fact be used in Hong Kong to pursue a corporate rescue provided the grounds for a provisional liquidation are to restructure debt to protect assets, rather than to avoid a winding-up altogether.

Guy Cowan
Partner

+1 345 914 5876
gcowan@campbellslegal.com

Harry Shaw
Counsel

+1 345 914 5869
hshaw@campbellslegal.com