Provisional Liquidation and Restructuring:

The Cayman Islands and Hong Kong

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> *As is well known, other than schemes of arrangement Hong Kong has no legislation that provides for corporate debt restructuring or rehabilitation. This unsatisfactory state of affairs has been the subject of much adverse comment for two decades now is brought into unforgiving focus by the economic problems that Covid-19 is causing. It makes it all the more important that the courts of Hong Kong and the Special Administrative Region's practitioners rise to the challenges we now face to find, within the flexibility of the common law, mechanisms to address the financial problems companies face. It is fortunate that great strides have been made in this regard in recent years as illustrated by the authorities referred to earlier in this decision. That having been said it is clearly desirable that some steps are taken immediately to improve the legislative position. Immediate (by which I mean the kind of alacrity shown in other major financial centres around the World in the last couple of months) amendment to section 193 of the Ordinance to provide expressly for provisional liquidators to be given restructuring powers is desirable.*[1]

Restructuring Reform

With the quote set out above, Mr Justice Harris, the Companies Court judge of the Hong Kong High Court, Court of First Instance, shone a spotlight yet again on a vexing issue that has persisted for many years in Hong Kong and in many offshore jurisdictions: the lack of any legislated, purpose-built corporate restructuring regime other than schemes of arrangement. This is in contrast to, for example, the United States' Chapter 11 process, the administration regimes in the UK and Australia and the new restructuring regime introduced in Singapore in 2017. Legislative reform in the area of restructuring and cross border insolvency has been mooted in Hong Kong for decades, with the Law Reform Commission having made recommendations to implement corporate restructuring legislation as far back as 1996. A similar push towards implementing a new corporate restructuring regime that operates outside of the context of liquidation has been gathering steam in the Cayman Islands for several years. Those efforts have most recently culminated in proposals that would allow Cayman companies to formally restructure their debts outside of a formal insolvency process under the supervision of a qualified insolvency practitioner acting in the capacity of a 'restructuring officer'. The restructuring officer would fill a role similar to that of a 'soft touch' (or 'light touch') provisional liquidator but without the stigma (and potential triggering of *ipso facto* clauses) that is attached to the liquidation process. There would be a stand-alone moratorium imposed to protect the company from creditor action during the period of the restructuring. When, or if, the current proposals might be formalised and put to the Cayman Islands Legislative Assembly for

1. 5 May 2020, Mr Justice Harris, High Court of Hong Kong Special Administrative Region in *The Joint and Several Provisional Liquidators of China Oil Gangran Energy Group Holdings Limited (in provisional liquidation in the Cayman Islands)* [2020] HKCFI 825 at [9].

consideration remains uncertain, but the Cayman profession remains eternally optimistic that reforms will be progressed in the relatively near future.

'Soft Touch' Provisional Liquidations in Offshore Jurisdictions

In the meantime, the Cayman Islands will continue to implement corporate restructurings through the use of schemes of arrangement, supported by 'soft touch' provisional liquidations. Bermuda largely follows the same process for the restructuring of companies in its jurisdiction. The scheme of arrangement regimes in both the Cayman Islands and Bermuda are largely modelled on the provisions of Part 26 of the UK Companies Act 2006 and the general processes and procedures for putting a scheme into place will therefore be familiar to English practitioners. English scheme case law is highly persuasive in the offshore jurisdictions and will be followed unless there are any particular local aspects that would justify divergence, which would be quite unusual.

It is possible for a well organised and pre-planned restructuring to be completed relatively quickly in the Cayman Islands, where the time from the filing of a scheme petition to the granting of court sanction of a scheme of arrangement can be as little as 12 weeks. Where, however, the scheme is complex, recognition of the scheme or parallel schemes are required to be implemented in other jurisdictions, or there is active and vocal dissent by creditor groups, the restructuring process can easily run its course over a much longer period. The breathing room offered by a provisional liquidation moratorium on claims during that period is therefore invaluable.

During the period where a restructuring proposal is being developed and promoted by the company, a practice has developed in the Cayman Islands and Bermuda (and more recently in the British Virgin Islands, as seen in the 2019 *Constellation* decision[2]) to seek the appointment of 'soft touch' provisional liquidators.

The High Court of the British Virgin Islands described 'soft touch' provisional liquidation in its decision in *Constellation* (at [3]) as follows:

The essence of a 'soft touch' provisional liquidation is that a company remains under the day to day control of the directors, but is protected against actions by individual creditors. The purpose is to give the Group the opportunity to restructure its debts, or otherwise achieve a better outcome for creditors than would be achieved by liquidation. It may be appropriate where there is no alleged wrongdoing of the directors.

The powers of 'soft touch' provisional liquidators are determined by the terms of the appointment order made by the Court and therefore each case will operate along a spectrum of debtor control.

At one end of the spectrum are cases where the directors' powers are suspended for the duration of the provisional liquidation and the provisional liquidators have full control of the restructuring process (for example, in the Cayman restructuring of *LDK Solar*[3]), which arguably is not actually 'soft touch' at all. At the other end of the spectrum are cases where the provisional liquidators' role and powers are expressly limited to the monitoring and supervision of the company's directors as the directors develop and promote a restructuring (for example, in the Cayman restructuring of *Arcapita Investment Holdings Limited*[4]), which is more akin to a traditional debtor-in-possession regime. The Court appointment order, and the powers granted to the provisional liquidators, will be typically be tailored to meet the requirements of the particular case.

The advantages that 'soft touch' provisional liquidations bring to a restructuring derive primarily from the statutory moratorium that is imposed on creditor action following the appointment of provisional liquidators (although secured creditors continue to be entitled to enforce their security). While provisional liquidators are appointed, no suit, action or other proceeding may be continued or commenced against the company except with leave of the Court and subject to such terms and the Court

2. *Re Constellation Overseas Ltd, Lone Star Offshore Ltd, Gold Star Equities Ltd, Olinda Star Ltd, Snover International Inc and Alpha Star Equities Ltd* BHIHC(COM) 2018/0206, 0207, 0208, 0210 and 0212.

3. FSD 14 of 2014.

4. FSD 45 of 2012].

may impose. This allows a distressed company time to develop and promote a restructuring plan, which will most frequently take the form of a scheme of arrangement.

Access to Restructuring Provisional Liquidation in the Cayman Islands

In order to access the provisional liquidation regime, a winding up petition must first be presented in respect of the company. This can often present a serious public relations challenge where the company conducts business in jurisdictions that are unfamiliar with the provisional liquidation process and its use in restructurings. It can be challenging to reassure directors, shareholders and creditors that the filing of a winding up petition is a necessary gateway to an eventual corporate restructuring, and not the beginning of a process that will lead to the eventual dissolution of the company. The winding up petition also risks triggering contractual defaults, impacting on the value of assets that might be sold as part of the restructuring and causing reputational damage with customers that the company may wish to retain. These issues are some of the strong drivers for the implementation of a corporate restructuring regime that stands outside of the liquidation process.

The Courts in both the Cayman Islands and Bermuda are accustomed to the appointment of 'soft touch' provisional liquidators for restructuring purposes. In the Cayman Islands, section 104(3) of the Companies Law expressly permits a company to apply ex parte for the appointment of provisional liquidators (at any time after the presentation of a winding up petition but before the making of a winding up order) if (1) the company is or is likely to become insolvent and (2) the company intends to present a compromise or arrangement to its creditors. In Bermuda, the power to appoint provisional liquidators for restructuring purposes was confirmed in the 1999 decision of Ward CJ (as he then was) in *Re ICO Global Communications (Holdings) Ltd*,[5] a case where the jurisdiction of the Bermuda Court to make a 'soft touch' provisional liquidation order was challenged, where he concluded:

"I am satisfied that the Court is given a wide discretion and had jurisdiction under section 170 of the Companies Act and Rule 23 of the Companies (Winding Up) Rules 1982 to make such an Order. Under it the directors of the Company remained in office with continuing management powers subject to the supervision of the joint provisional liquidators and of the Bermuda Court."

Where an order is made to appoint provisional liquidators, the Court will usually adjourn any extant winding up petitions to facilitate the restructuring. As recently confirmed in *Re Sun Cheong Creative Development Holdings Limited*,[6] the Cayman Islands Grand Court's discretion to appoint provisional liquidators to facilitate a corporate restructuring is broad and flexible. The Chief Justice in that case noted that there is no prescriptive list of factors to be taken into consideration by the Court when exercising that discretion, but cited (at [37]) the following as matters to which the Court may have regard:

"(1) The express wishes of creditors (though the Court should be cautious not to "count up the claims of supporting and opposing creditors"): Segal J in Re Grant T G Gold Holdings;[7]

(2) Whether the refinancing is likely to be more beneficial than a winding up order: Re Fruit of the Loom Ltd;[8]

(3) That there is a real prospect of refinancing and/or a sale as a going concern being effected for the benefit of the general body of creditors: Re Fruit of the Loom Ltd; and

(4) The considered views of the board as to the best way forward: Re CW Group Holdings Limited.[9]

In the Cayman Islands, there is an additional hurdle that a company seeking to take advantage of provisional liquidation as part of its restructuring strategy must overcome. The 2015 decision in *Re China Shanshui Cement Group Limited*[10] made it clear that the relevant provision

5. [1999] Bda LR 69 at [6].

6. Unreported, Smellie CJ, 20 October 2020, Cause No. 169 of 2020 (ASCJ).

7. Unreported, Segal J, 21 August 2016, Cause No. FSD 84 of 2016 (NAS)) at [6(f) (iv)].

8. Unreported, Smellie CJ, 26 September 2000, Cause No. FSD 823 of 1999 (ASCJ).

9. Unreported, Parker J, 3 August 2018, Cause No. FSD 113 and 122 of 2018 (RPJ).

10. [2015 (2) CILR 255].

of the Cayman Islands Companies Law[11] requires a winding up petition to be presented by one of the company, its creditors, its contributories or (for regulated businesses) the Cayman Islands Monetary Authority. There is no current legislative authority for a company's directors to cause a winding up petition to be presented unless they have been explicitly granted that power in the company's Articles of Association or have obtained prior authorisation to do so by a resolution of the company's shareholders.

Where that is an issue, a practical work-around has been to have a 'friendly' creditor present the winding up petition, rather than the company. This approach was approved by the Cayman Grand Court in the decision of *Re CHC Group Ltd*[12]. In that case, the company was seeking to have provisional liquidators appointed in order to assist with the implementation of its US Chapter 11 restructuring plan. The company's directors, recognising that following the decision in *China Shanshui* they could not cause the company to petition for its own winding up without shareholder approval, arranged for a related, 'friendly' creditor to present a winding up petition and then immediately caused the company to
file its own application for the appointment of 'soft touch' provisional liquidators under section 104(3). The Court granted the company's application. The reasoning in *CHC Group* has since been followed in *Re CW Group Holdings Limited* at [30] where the Judge stated:

"There is no dispute that the company may act, as it does here [in making an application for 'soft touch' provisional liquidators under section 104(3) following presentation of a winding up petition by a creditor], through its board of directors without the sanction of a resolution of shareholders passed in general meeting".

Neither of the decisions in *CHC Group* and *CW Group* addressed the provisions of Order 4, rule 6(1) of the Cayman Islands Winding Up Rules 2008 (as amended) which state: *"Whenever a winding up petition is presented by the company itself the company may apply by summons for an order for the appointment of a provisional liquidator on the grounds contained in section 104(3) of the Law"*. On its face, this would arguably appear to limit the ability of a company to seek orders appointing 'soft touch' provisional liquidators to cases where the company had filed the underlying winding up petition itself – which then squarely revives the original *China Shanshui* difficulties discussed above. It is not apparent from the judgments in either case whether the Court's attention was drawn to this rule, and so there remains the possibility that the 'friendly creditor' work around may in future be subject to challenge.

Access to Restructuring Provisional Liquidation in Hong Kong

Hong Kong has its own difficulties for companies wishing to use provisional liquidation for restructuring purposes. These stem from the impact of the decision of the Hong Kong Court of Appeal in *Re Legend International Resorts Ltd*[13]. That decision held that the statutory power to appoint provisional liquidators under s193 of the Hong Kong Companies Ordinance (Cap 32) may not be exercised for the sole purpose of restructuring a company's debt. While provisional liquidators in Hong Kong may be granted the power to promote a restructuring, for an appointment to be made in the first place the traditional protective grounds of provisional liquidation must be engaged – that is, the petitioner must establish that the assets of the company are in jeopardy and the appointment of provisional liquidators is necessary to preserve the status quo pending a determination of an extant winding up petition.[14]

Prior to the Legend decision, the Hong Kong Court regularly used provisional liquidation as a tool to assist in corporate rescues, as it continues to be used today in the offshore jurisdictions. Since the *Re Legend* decision, the Hong Kong Court has affirmed on numerous occasions that, notwithstanding the fact that it has no free-standing jurisdiction to appoint restructuring provisional liquidators, it does have jurisdiction at common law to recognise and assist restructuring provisional liquidators appointed by foreign Courts.[15]

This has led to the rather odd situation where in practice 'soft touch' provisional liquidations for restructuring purposes are regularly recognised and assisted by the Hong Kong court, but exclusively in respect of companies incorporated outside of Hong Kong (most often in the Cayman Islands or Bermuda). While odd, this does serve a very practical purpose in Hong Kong, where over 52% of the 2,071 companies listed on the Main Board of the Hong Kong Stock Exchange are incorporated in the Cayman Islands or Bermuda, as are over 91% of the 378 companies on the Growth Enterprise Market of the exchange (all figures as at the end of 2019).

Justice Harris recently commented on the situation in his August 2020 decision in *Agritrade Resources*[16] stating:

"The proliferation of applications for recognition and assistance in recent years in Hong Kong is largely to be explained by a combination of factors: the corporate structure of many Chinese business groups, the lack of any relevant corporate restructuring legislation in Hong Kong and the impact of the Court of Appeal's decision in Re Legend International Resorts Ltd. Chinese business groups' principal business activities normally take place in the Mainland, but the group

11. Section 94.

12. Unreported, McMillan J, 24 January 2017, Cause No. FSD 5 of 2017 (RMJ).

13. [2006] 2 HKLRD 192.

14. *Re China Solar Energy Holdings Ltd* [2018] HKCFI 555.

15. See the recent examples of: *Re Z-Obee Holdings Ltd* [2017] HKCFI 2204; *Re the Joint Provisional Liquidators of Hsin Chong Group Holdings Ltd (provisional liquidators appointed) (for restructuring purposes only)* [2019] HKCFI 805; *Re the Joint Provisional Liquidators of Moody Technology Holdings Ltd (in provisional liquidation for restructuring purposes)* [2020] HKCFI 416; *Re China Oil Gangran Energy Group Holdings Limited (in provisional liquidation in the Cayman Islands)* [2020] HKCFI 825; *Re the Joint Provisional Liquidators of Agritrade Resources Ltd (in provisional liquidation in Bermuda)* [2020] HKCFI 1967; *Re the Joint and Several Provisional Liquidators of Rare Earth Magnesium Technology Group Holdings Ltd (in provisional liquidation in Bermuda)* [2020] HKCFI 2260.

16. *Re the Joint Provisional Liquidators of Agritrade Resources Ltd (in provisional liquidation in Bermuda)* [2020] HKCFI 1967 at [4] and [5].

> …I hope that in future this is what will occur and this decision is shown to judges in offshore jurisdictions

*holding company is based in Hong Kong, commonly listed here and incorporated in an offshore jurisdiction. Recognition and assistance has come to be used in one of two situations. The **first** is to avoid arguments over jurisdiction that can arises if a winding-up petition is presented in Hong Kong. The **second** involves the use of soft-touch provisional liquidation in the jurisdiction of incorporation, which has come to be used as a technique to overcome the limitations in Hong Kong's own system. As will be apparent from this summary the applications are not driven by events occurring in the offshore jurisdictions. They are driven by events occurring in Hong Kong and the Mainland and techniques developed in Hong Kong.*

Particularly in the case of the second category I have aimed to establish a process, which provides for quick, cost effective and, so far as possible, uncontroversial recognition and assistance. I have made clear in a number of decisions and also talks to the profession that it is important that the procedures and standard orders that have been developed are used. I have suggested that so far as possible, for example, the letters of request are drafted to be consistent with the Hong Kong procedure and order.... I hope that in future this is what will occur and this decision is shown to judges in offshore jurisdictions in order that they understand the Hong Kong court's approach."

The principles on which the Hong Kong Court will grant recognition and assistance to foreign insolvency proceedings are well settled and were recently reiterated by the Court in *CEFC Shanghai International Group Limited*.[17] Recognition will be granted if:

(1) the foreign insolvency proceeding is a collective insolvency proceeding (which will include provisional liquidations); and

(2) the foreign insolvency proceeding is opened in the company's country of incorporation.

The eligibility criteria do not require the foreign insolvency proceeding to be capable of being opened in Hong Kong.

The assistance that the Hong Kong Court may grant extends to allowing the foreign provisional liquidators to pursue restructuring options in Hong Kong.[18] Thus the foreign provisional liquidators, once recognised, will be able to undertake actions in Hong Kong that are largely unavailable

17. [2020] HKCFI 167 at [8].

18. *Re Z-Obee Holdings Ltd* [2017] HKCFI 2204.

19. *Re the Joint Provisional Liquidators of Moody Technology Holdings Ltd (in provisional liquidation for restructuring purposes)* [2020] HKCFI 416 at [27] and [28].

to locally appointed provisional liquidators (unless their original appointment satisfies the requirements for a traditional protectionary provisional liquidation).

Earlier this year, the Hong Kong Court commented on this situation, stating in *Moody Technology*:[19]

"Therefore, foreign provisional liquidators recognised in Hong Kong will not be acting as, acting in the capacity of, or having the status of provisional liquidators appointed by Hong Kong Courts. It follows that the fact that Hong Kong Courts may not appoint domestic soft-touch provisional liquidators cannot constitute a bar to recognising and assisting foreign soft-touch provisional liquidators.

To say that recognising foreign soft-touch provisional liquidators would be to bypass and circumvent the Hong Kong domestic provisional liquidation regime would be to misunderstand the true notion of recognition."

While the Hong Kong Court has left no doubt of its willingness to accede to letters of request issued by foreign courts for the recognition and assistance of foreign restructuring provisional liquidations, in the *Agritrade Resources*[20] and *Rare Earth Magnesium Technology*[21] decisions of August and September 2020 Justice Harris has made it clear that the Court expects applicants to adhere to the streamlined recognition process that has been established and, unless reasonable justification can be shown, to use the standard form of recognition orders that have been approved.

In *Agritrade*, Justice Harris refused to grant a recognition order in the form sought by the applicants on the ground that it was materially different from the standard form. In *Rare Earth Magnesium*, Justice Harris was persuaded to grant orders for the recognition and assistance of 'soft touch' restructuring provisional liquidators that varied from the standard form to address the fact, by virtue of the limited powers granted to the provisional liquidators by the Bermuda Court, a number of the traditional powers granted in the recognition order would only be exercisable with the consent of the company.

In each of the decisions in *Agritrade* and *Rare Earth Magnesium* Justice Harris has appended a copy of the form of order for recognition and assistance that was made. Foreign practitioners would be well advised to take note and to be prepared to offer cogent reasons for any variation to the standard order that they may wish to seek. The Hong Kong Court will expect that any letter of request seeking its assistance will have been prepared with the form of standard order in front of mind.

As Justice Harris noted in the quote that began this article, great strides have been made in recent years by offshore and Hong Kong practitioners and Courts to creatively use the common law cross-border recognition tools at their disposal to compensate for the inability of the Hong Kong Court to appoint provisional liquidators for restructuring purposes alone. By availing themselves of the long standing 'soft touch' provisional liquidation regimes in the offshore jurisdictions, companies incorporated in those offshore jurisdictions have been able to effectively implement corporate and financial restructurings in Hong Kong that would not have otherwise been possible. That effectiveness, however, has its limits and both Hong Kong and the Cayman Islands would benefit from the kinds of corporate restructuring legislative reforms that are being called for in those jurisdictions. ■

20. *Re the Joint Provisional Liquidators of Agritrade Resources Ltd (in provisional liquidation in Bermuda)* [2020] HKCFI 1967.

21. *Re the Joint and Several Provisional Liquidators of Rare Earth Magnesium Technology Group Holdings Ltd (in provisional liquidation in Bermuda)* [2020] HKCFI 2260.