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Insights

"DIVIDING LINE" IN PUBLIC POLICY – INSOLVENCY AND ARBITRATION

THE WAY FORWARD AFTER *SIAN* AND *GUY LAM*

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SUMMARY

A creditor commences winding-up proceedings against a debtor company on the basis that the company is insolvent. The petition debt relates to a dispute within the ambit of the arbitration agreement between the creditor and the debtor. Should the Court either:-

1. Uphold the parties' agreement to arbitrate (and stay / dismiss the winding-up); or

2. Allow the creditor to continue to pursue the debt in winding-up proceedings?

In our previous article on the topic in August 2020, we discussed Lasmos approach and the inter-relationship between arbitration and insolvency proceedings through the cases of: (1) the HKCFI case *Lasmos* (Lasmos Limited v Southwest Pacific Bauxite (HK) Limited [2018] HKCFI 426), (2) the English CA case *Salford Estates*(Salford Estates (No 2) Ltd v Altormart Ltd (No 2) [2015] Ch 589), (3) the two HK CA cases *But Ka Chon* (But Ka Chon v Interactive Brokers LLC [2019] HKCA 873) and *Sit Kwong Lam* (Sit Kwong Lam v Petrolimex Singapore Pte Ltd [2019] HKCA 1220), and (4) the HKCFI case of *Dayang* (Dayang (HK) Marine Shipping Co., Limited v Asia Master Logistic Limited [2020] HKCFI 311).

The common law position has now been further developed in a number of important Court decisions, including judgments from the highest Courts in HK and the UK, i.e. the HKCFA and the UK Privy Council hearing an appeal from the BVI Courts. In the HKCFA case of *Re Guy Lam* (Re Guy Kwok Hung Lam [2023] HKCFA 9), the traditional English position in *Salford Estates* is largely followed. By contrast, in the Privy Council case of *Sian* (Sian Participation Corporation (In Liquidation) v Halimeda International Ltd [2024] UKPC 16), the traditional English position in *Salford Estates* was held to be wrong in principle.

This article seeks to re-visit and distil, at a very high level, the contrasting positions between the HK and the UK Courts, and explores two post-*Sian* HK cases reaffirming the *Re Guy Lam* approach through the principle of *stare decisis* (instead of following the Privy Council approach in *Sian*).

These two recent HK decisions are – HKCFI case of *Re Mega Gold* (*Re Mega Gold and Re Man Chun Sing Matthew*, heard together in [2024] HKCFI 2286) and CA case of *Re Inversion* (*Re Inversion Productions Ltd* [2024] HKCA 884).

OVERVIEW – HK POSITION VS UK POSITION

The HK position had developed through the cases of: (A) *Guy Lam* (Guy Kwok-Hung Lam v Tor Asia Credit Master Fund LP [2023] HKCFA 9), (B) *Re Simplicity* (Simplicity & Vogue Retailing (HK) Co., Limited [2024] HKCA 299), and (C) *Re Shandong* (Re Shandong Chenming Paper Holdings Limited [2024] HKCA 352).

Subsequent to the above three HK cases, the UK position had then been radically shifted through the Privy Council judgment in *Sian* (the Privy Council in *Sian*made it clear that the views in that case represented the law in England and Wales, through a *Willers v Joyce* direction). The *Sian* judgment reviewed and considered the HK position through discussion of *Guy Lam*, *Re Simplicity*, and *Re Shandong*, as well as the previous HK cases of *Dayang* and *But Ka Chon* (as discussed in our previous article in August 2020).

At a very high level, the contrasting positions can be summarised roughly as follows:

Privy Council (England and Wales and BVI) approach in *Sian*:

- *Sian* held that a winding-up petition would not be stayed where the underlying debt is subject to an arbitration agreement, unless the debt is **genuinely disputed on substantial grounds**
- The traditional English position in *Salford Estates* (namely that, in practice, it is likely that there will be an automatic stay of winding-up petitions when the underlying dispute is subject to an arbitration clause) was held to be **wrongly decided** – the English Court of Appeal was wrong to have introduced a discretionary stay of winding-up petitions "*where an insubstantial dispute about the creditor's debt was raised by parties to an arbitration agreement*"

HK approach in *Guy Lam, Re Simplicity, Re Shandong*:

- Traditional English position in *Salford Estates* is **largely followed**, i.e. namely that, in practice, it is likely that there will be an automatic stay of winding-up petitions when the underlying dispute is subject to an arbitration clause
- The parties' arbitration agreement generally will be respected and upheld, absent countervailing factors, e.g. abuse of process, risk of insolvency affecting third parties

BACKGROUND – TENSION BETWEEN "PUBLIC" VS "PRIVATE"

Insolvency and arbitration are both important, but conceptually very different, areas of law and social institutions. As the judgment of *Sian* highlights, there are situations where the "dividing line" between these two areas of public policy need to be drawn – although it may not, at first sight, be easy to see how these two areas of law might conflict with each other.

Insolvency, conceptually, consists of a debtor's ultimate inability to meet its financial commitments, whether in very broad terms by a "balance-sheet" test (liabilities exceed assets, i.e. impossible for all liabilities to be discharged in full) or by a "cash-flow" test (inability to meet obligations at the time of falling due). It is in the public interest for there to be a straightforward means by which an insolvent company be placed in an insolvency process, whereby its assets are divided fairly – through the *pari passu* principle of distribution – between **all** its creditors. Each jurisdiction has its own domestic insolvency regime, which reflects its own economic objectives and public policy.

On the other hand, arbitration is a consensual method of private dispute resolution, and in line with the principles of party autonomy and freedom of contract, public policy dictates that parties who have contracted to have disputes resolved privately by arbitration should be held to that arbitration agreement, without any interference from domestic courts. In a sense, arbitration is a delocalised dispute mechanism recognised globally, particularly given the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards 1958, whereby the 170+ signatory states agree that their local courts will treat arbitration awards made in one convention state as if they were local judgments of their own state, with minimal grounds for judicial interference.

Under common law, the Courts generally do not allow a creditor to seek the winding-up of a company on the basis of a disputed debt. If there is no dispute as to the debt, there is, of course, no dispute for the arbitration clause agreed between the parties to take effect in relation to that debt. However, what happens when the petitioning debt itself is in fact (as is often the case) disputed, and such dispute is subject to an arbitration clause? Should the Courts exercise its jurisdiction to hear the winding-up petition, and ignore the arbitration clause entirely? Or should the Courts pay deference to party autonomy, and stay the winding-up petition for the dispute to be resolved by arbitration instead?

In such a situation, there is a tension between the "public" and the "private" which the Courts must balance. Non-payment of a debt by a debtor who is otherwise solvent (e.g. mere refusal to pay or omission to pay) is purely a "private" issue of enforcement of rights as between the debtor and that particular creditor. However, non-payment of a debt by a debtor in the context of insolvency introduces a different dimension – the notion that the interests of all creditors of the same debtor should be taken into account under the principle of collectivity, i.e. it becomes a "public" issue concerning the collective rights of all other creditors, not just that particular creditor. The arbitration clause is "private" in the sense that it applies to the contracting parties, but the parties cannot exclude the "public" or collective rights of all other creditors.

We will now discuss, briefly, how the debate has unfolded, through various stages.

PRE-*SALFORD ESTATES* – BONA FIDE SUBSTANTIAL DISPUTE (FACT-FINDING BY THE COURTS)

The first stage was the "old" common law position.

In the insolvency regime, where a petition debt is bona fide disputed on substantial grounds, the ordinary practice in common law is for the Court to dismiss / stay a winding-up petition. This general rule of practice, and its justification, was set out in the Privy Council case of *Parmalat Capital Finance Limited v Food Holdings Limited and Dairy Holdings Limited* [2008] B.C.C. 371 by Lord Hoffman: "*If a petitioner's debt is* ***bona fide disputed on substantial grounds****, the normal practice is for the court to dismiss the petition and* ***leave the creditor first to establish his claim in an action****. The main reason for this practice is the danger of abuse of the winding-up procedure. A party to a dispute should not be allowed to use the threat of a winding-up petition as a means of forcing the company to pay a bona fide disputed debt. This is a rule of practice rather than law and there is no doubt that* ***the court retains a discretion to make a winding-up order even though there is a dispute****.*" (emphasis added)

This "old" common law position **does not change** even if the disputed petitioning debt is subject to an arbitration clause. In other words, under the "old" common law position, the arbitration clause was, in effect, ignored. The general rule of practice remained that the Court would not proceed with the winding-up if the debtor can establish a **bona fide dispute on substantial grounds** with regards to the petitioning debt.

SALFORD ESTATES – PRO-ARBITRATION APPROACH (VIRTUALLY AN AUTOMATIC STAY)

The next stage was this English Court of Appeal ruling in late 2014.

In *Salford Estates*, the UK Court of Appeal upheld a first instance decision to dismiss a winding-up petition where there was an arbitration clause in the lease from which the alleged debt was said to have arisen – the judgment stated that: "*… it was right for the court either to dismiss or to stay the Petition so as to compel the parties to resolve their dispute over the debt by their chosen method of dispute resolution rather than require the court to investigate whether or not the debt is bona fide disputed on substantial grounds.*" In other words, save in "*wholly exceptional circumstances*", the position adopted here was that the Court readily would stay / dismiss a winding-up petition, instead of inquiring whether the debt was disputed in good faith on substantial grounds. In other words, the "old" common law position was not engaged.

As expressed in *Sian*, the *Salford Estates* position meant that there virtually would be a mandatory stay of the petition when the petitioning debt is not admitted: "*the discretion to wind up would be virtually illusory where the debt relied on by the petitioner was merely not admitted, even if not genuinely disputed on substantial grounds. There would in such circumstances be, in substance,*

virtually a mandatory stay of the petition …". This was because the arbitration agreement would be engaged whenever a "dispute" existed between the parties to the arbitration agreement.

GUY LAM, RE SIMPLICITY, RE SHANDONG

The next broad stage is these three Hong Kong decisions in 2023 and 2024.

In *Guy Lam*, it was held that, in the context of an exclusive jurisdiction clause (EJC), ordinarily: "… *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 petitioner and the debtor ought to be held to their contract*".

Some key points in the HKCFA's reasoning are:

- The determination of whether the petition debt is bona fide disputed on substantial grounds is a "*threshold question*" and is part of the exercise of the court's insolvency jurisdiction
- A circumstance where the Court would decline to exercise its insolvency jurisdiction is when the parties have agreed to have all disputes under the agreement giving rise to the debt to be determined exclusively in another forum, e.g., an EJC
- Two public policy considerations are involved – "*the public policy interest in holding parties to their agreements*", versus "*the public policy underpinning the legislative scheme of the court's bankruptcy jurisdiction*" (in other words, the "private" vs "public" tension as mentioned above)
- An EJC would engage the public policy interest in holding parties to their agreements
- Two relevant matters would engage the public policy underpinning the legislative scheme of the court's insolvency jurisdiction: (1) "*the more obviously insubstantial the grounds for disputing the debt, the more it comes into prominence*", and (2) where the creditor community is at risk, which may be evidenced by another creditor presenting a petition
- Whether the discretion should be exercised is to be decided by a "*multi-factorial*" approach, and depending on a "*range of considerations*"

Re Simplicity and *Re Shandong* (handed down on the same day by the HK Court of Appeal) extended the approach in *Guy Lam* to arbitration clauses and cross-claims (cross-claims advanced in an arbitration commenced pursuant to an arbitration clause).

Some key points in the HKCA's reasoning in these two judgments were:

- Whether (1) the grounds for disputing the debt are obviously insubstantial, or (2) there is a supporting creditor or evidence of the creditor community at risk, are merely two **examples** of the factors that the court should take into account

- It is important for the court to "retain flexibility" to deal with the case as the circumstances require
- It is "not onerous" for the debtor to demonstrate that there is a genuine intention to arbitrate – this is to deter a debtor from merely raising the existence of an arbitration clause as a tactical move
- The Court can take into account the steps taken to commence the agreed resolution process, which include preliminary stages such as mediation
- If these steps have yet to be embarked on, a short adjournment for the parties to commence those steps may be considered; if no progress is made during the adjournment, the Court could consider exercising its insolvency jurisdiction

SIAN

The next stage was the Privy Council (BVI jurisdiction) decision in *Sian* in 2024.

The Privy Council in *Sian* took a view different from that of the HKCFA in *Guy Lam*, and held that as a matter of English law: "… *the correct test for the court to apply to the exercise of its discretion whether to make an order for the liquidation of a company where the debt on which the application is based is subject to an arbitration agreement or an exclusive jurisdiction clause and is said to be disputed is* ***whether the debt is disputed on genuine and substantial grounds***". (emphasis added)

The Privy Council ruled that *Salford Estates* was **wrongly decided**.

Some key points in the Privy Council's reasoning in *Sian* are:

- There was an "*impermissible and unexplained leap in the reasoning [in Salford Estates] as to the extent of the legislative policy behind the [arbitration legislation]*"
- A winding-up or liquidation order based on a debt not disputed on substantial grounds (i.e. which does not meet the threshold of the "old" common law approach) does **not** offend the general objectives of the arbitration legislation, because it does not seek to resolve anything about the underlying debt, or interfere with the resolution of any dispute about the debt
- A winding-up or liquidation order is not a "matter" subject to that arbitration agreement, and seeking a liquidation order cannot be said to be something the creditor has promised not to do
- Requiring a creditor to go through arbitration where there is no genuine or substantial dispute unnecessarily adds delay, trouble and expense "for no good purpose"
- The English Court of Appeal in *Salford Estates* was wrong to have introduced a discretionary stay of winding-up petitions where an **insubstantial** dispute about the creditor's debt was

raised by parties to an arbitration agreement (i.e. the virtually automatic stay was held to be wrong in principle)

Sian meant that the English Courts reverted to the "old" common law position (see "Pre-*Salford Estates*" section above) – bona fide substantial dispute on substantial grounds / whether the debt is disputed on genuine and substantial grounds.

HK COURT'S DECISION IN *RE MEGA GOLD* AND *RE INVERSION*

The final stage (perhaps for the time being?) relates to the two most recent Hong Kong judgments in *Re Mega Gold* and *Re Inversion* in 2024.

In *Re Mega Gold*, after discussion of the relevant English and HK authorities above, the HKCFI followed the reasoning in *Guy Lam* and *Re Simplicity*, and did so as a matter of *stare decisis* and on the basis of binding Hong Kong authority.

Some important points made in *Re Mega Gold* include:

- One should **not** equate the tests for determining (1) whether a dispute is bona fide disputed on substantial grounds in an ordinary winding-up petition, with (2) whether a dispute "*borders on the frivolous or an abuse of process*", because the threshold for the latter is high.
- The concepts regarding a claim or defence being "frivolous" or constituting an "abuse of process" are commonly found in the context of striking out applications, and this rather high threshold to overcome involves questions that are always fact-specific.
- Ordinarily, it is necessary to establish that the claim or defence is bound to fail and does not warrant a chance to be further investigated at trial. The Court should only conduct a preliminary assessment on whether it is a plain and obvious case that the dispute is "frivolous" or amounts to an "abuse of process"**without attempting to undergo a mini-trial on affidavit evidence**.
- Unless a plain and obvious case is shown, the court should be more ready to exercise discretion to decline exercising insolvency jurisdiction, leaving the dispute to be resolved by the parties' contractually agreed arbitration mechanism, with regard to the public policy in holding the parties to their agreement.
- The threshold for showing a genuine intention to arbitrate is not a high one – even if a party has not taken steps under the arbitration clause, the court may nevertheless grant a short adjournment to allow the party to take such steps.

The Court is not straightjacketed by any particular policies and interests, i.e. retains flexibility in a multi-factorial approach.

In *Re Inversion*, the CA in HK simply referred to its (the Court of Appeal's) earlier judgment in *Re Simplicity* that the *Guy Lam* approach should be applied by analogy where there is an arbitration agreement between the parties: "*It is common ground, therefore, that unless the court finds that the Borrower's dispute of the debt borders on the frivolous or abuse of process,* ***it should refer the parties to arbitration****, there being no other reason for not giving effect to their agreement.*" (emphasis added)

BCLP DISCUSSION

Academic commentary has been mixed regarding where to draw the "dividing line" between insolvency and arbitration. Some commentators suggest that to apply the approach of *Salford Estates* (virtually an automatic stay) may actually hinder rather than promote a pro-arbitration policy, because prospective creditors might resist the inclusion of an arbitration clause in their contracts if this has the effect of reducing, or making slower and more expensive, their remedies in the event of an insolvency of the debtor.

As explained above, the Courts are seeking to balance the tension between the "public" (insolvency) and the "private" (arbitration). The above line of cases may also be better understood from the perspective of competing policy priorities of insolvency law and arbitration law, and **which of the parties' rights is most relevant to the dispute**. As explained in the journal article, "Arbitration agreements and the winding-up process: reconciling competing values I.C.L.Q. 2023, 72(2), 309-332":-

Insolvency

The insolvency regime focuses on the **right to the payment of a debt**, and adopts an expansive understanding of this right. At the stage where a creditor brings a winding-up petition, there is no consideration of the debtor's actual financial position, or the existence or interests of other creditors. In other words, a single creditor can put a debtor under significant pressure with relative ease, even where there is no evidence of the debtor actually being in financial distress. The burden is then on the creditor to show that the debt is bona fide disputed on substantive grounds and that the petition is therefore an abuse of process.

The policy values underpinning modern insolvency law can be grouped under three broad headings: (1) ensuring the fair distribution of an insolvent entity's assets between creditors, (2) maximising the return to creditors, and (3) protecting the public interest.

Arbitration

In contrast, the focus of the arbitration regime is the prior issue of **how the parties have agreed to settle their disputes**. When dealing with a "forum" dispute, the courts are generally unconcerned with the substantive rights of the parties, and only with ensuring that the dispute is heard and resolved in the appropriate forum. To ensure this, arbitration law only requires a debtor to show the existence of

an arbitration agreement and a genuine dispute, and assessing whether the dispute was "substantive" would itself undermine the arbitration agreement.

The policy values underpinning modern arbitration law are dominated by: (A) party autonomy, (B) *pacta sunt servanda* (i.e. the principle that "agreements must be kept"), and (C) efficiency.

We should also bear in mind that the date of the winding-up petition is of specific and particular importance in balancing the "public" vs the "private" spheres – generally, the winding-up of the company shall be deemed to commence **at the time of the filing of the petition for winding-up**, after which any disposition of the property of the company (including any transfer or shares or alteration in the status of the shareholders of the company) is **void**, unless the court orders otherwise.

A multi-factorial, categorisation approach (such as the *Guy Lam* approach in HK) should consider factors that assist a court to identify whether the case is one where (A) there are real concerns about the debtor's financial position, versus (B) whether it is closer to a standard disputed debt in which there are no indications that the debtor is in financial distress – or indeed, it may be a matter of where the case sits on a sliding scale between (A) and (B) above. Some of the factors which may be relevant include: (1) the existence of other creditors, (2) the nature of the application being made by the creditor, (3) the existence of suspicions justifying the investigation of the debtor, (4) the debtor having admitted the debt, and (5) the creditor's subjective reason for making its application.

With the above in mind, let us revisit the question posed at the start of this article. Should the Court:

1. Uphold the parties' agreement to arbitrate (and stay / dismiss the winding-up); or

2. Allow the creditor to continue to pursue the debt in winding-up proceedings?

HK currently leans towards (1), while the UK currently leans towards (2). It remains to be seen how the UK position post-*Sian* and the HK position post-*Guy Lam* will develop over time in the coming years, and it will be interesting how common law jurisdictions (continue to) attempt to draw a fair and just "dividing line" between insolvency and arbitration. The welter of recent cases suggests that this may be an area that continues to be ripe for debate.

RELATED PRACTICE AREAS

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