Client Alert

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The New Cross-Border Arrangement Between Hong Kong and Mainland China on Insolvency and Restructuring Matters – A Comparison with Chapter 15 of the United States Bankruptcy Code

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On May 14, 2021, the Department of Justice of the government of the Hong Kong Special Administrative Region announced that the Secretary for Justice of Hong Kong and the Vice-president of the Supreme People's Court (the "SPC") had signed the Record of Meeting on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the Mainland and of the Hong Kong Special Administrative Region (the "ROM"). The ROM concerns the commencement and implementation of the much anticipated cross-border mutual recognition, assistance and cooperation arrangement between Hong Kong and mainland China (the "Mainland") in relation to corporate insolvency and restructuring matters (the "Cooperation Arrangement").

To give effect to this milestone agreement, on the same day the SPC issued The Supreme People's Court's Opinion on Taking Forward a Pilot Measure in relation to the Recognition of and Assistance to Insolvency Proceedings in the Hong Kong Special Administrative Region (the "SPC Opinion") and the Hong Kong government issued a Practical Guide setting out the procedure for a Mainland administrator's application to the Courts of Hong Kong for recognition and assistance (the "Guide").

The Cooperation Arrangement will initially be implemented as a pilot program by the people's courts in Shanghai Municipality, Xiamen Municipality in Fujian Province and Shenzhen Municipality in Guangdong Province (together the "Pilot Courts") given their close financial and business connections with Hong Kong. It is anticipated that other Mainland courts will be added to the arrangement in the future if the pilot program is successful.

This is a groundbreaking development as it is the first time that either the Mainland or Hong Kong has entered into a cooperation framework with any other jurisdiction in respect of cross-border insolvency and restructuring matters. The true implications of this development for creditors and market participants in Hong Kong-China restructuring and insolvency matters will, however, only become clear once the first

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test cases begin to emerge and we see how the Cooperation Arrangement is applied in practice.

While we await further clarification and guidance from those cases, we highlight in this article the key features of the Cooperation Arrangement and consider how it compares to the recognition and assistance mechanisms available under chapter 15 of the United States ("U.S.") Bankruptcy Code ("chapter 15"), which was enacted following the adoption by the U.S. of the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross Border Insolvency (the "Model Law") in 2005. The Model Law is a framework for dealing with cross-border insolvency and restructuring matters that has so far been adopted in 49 States in a total of 53 jurisdictions around the world[1]. Finally, we consider the potential ramifications of the Cooperation Arrangement for offshore creditors and insolvency officeholders in Hong Kong.

Although the Cooperation Arrangement does have some limitations relative to chapter 15, it is an important and positive development for the Hong Kong-China insolvency and restructuring landscape and will give Hong Kong insolvency officeholders an advantage in Chinese group failures that have a sufficient nexus to Hong Kong and one or more of the Pilot Court jurisdictions.

Recognition of Mainland Insolvency Proceedings in Hong Kong

Hong Kong has not adopted the Model Law, nor does it have any statutory mechanism to deal with cross-border insolvency and restructuring matters. Instead, the Hong Kong courts have, over the years, developed and refined a common law framework for addressing such issues. An overview of the relevant common law principles can be found in our recent Client Alert.

These common law principles have already been successfully applied on at least two occasions to recognize Mainland insolvency proceedings, in the decisions of *Re CEFC Shanghai International Group Limited*[2] and *Shenzhen Everich Supply Chain Co, Ltd*[3].

The ROM and the Guide contemplate that the recognition of Mainland insolvency proceedings in Hong Kong will continue to be dealt with under the existing common law framework in Hong Kong. The procedure for seeking recognition of a Mainland insolvency proceeding will continue to involve the issuance of a letter of request by a Mainland court addressed to the Hong Kong Companies Court for the purpose of seeking recognition and assistance, usually on terms that reflect the Hong Kong Companies Court standard order (unless there is a good reason to deviate from those terms in a particular case).

Under the Cooperation Arrangement, the Hong Kong Companies Court may grant (i) recognition of bankruptcy liquidation, reorganization and compromise proceedings under the Enterprise Bankruptcy Law of the People's Republic of China (the "EBL"); (ii) recognition of a Mainland bankruptcy administrator's office as an administrator; and (iii) assistance with the discharge of the bankruptcy administrator's duties as an administrator.

Recognition of Hong Kong Insolvency Proceedings in the Mainland

Since 2007, the Mainland has had a statutory mechanism available to deal with cross-border insolvency matters in the form of Article 5 of the EBL. This gives the Mainland

courts discretion to recognize and enforce judgments or rulings in foreign bankruptcy cases according to international treaties or on the basis of the principle of reciprocity. Recognition and enforcement on this basis is subject to the proviso that the judgment or ruling does not violate the basic principles of Mainland law, does not jeopardize the sovereignty and security of the state or public interests and does not undermine the legitimate rights and interests of creditors in the Mainland.

The Mainland has not signed any international treaties with other jurisdictions in respect of cross-border insolvency and restructuring matters (other than the recent Cooperation Arrangement with Hong Kong) and, to date, Article 5 has had very limited utility in practice, notwithstanding that Mainland bankruptcy proceedings have been granted recognition in a small number of cases in foreign jurisdictions.

Unlike Hong Kong, the Mainland does not have a common law system, and its courts are not formally bound by rigid precedent as they are in Hong Kong. Consequently, a different approach was required for a recognition and assistance regime to operate effectively in the Mainland compared with the common law precedent-based approach in Hong Kong. Although the Mainland has not adopted the Model Law, certain features of the Mainland recognition and assistance regime as contemplated by the Cooperation Arrangement have been influenced by the Model Law, although, as we highlight below, it deviates from the Model Law in a number of significant respects.

A Comparison of Chapter 15 and the Cooperation Arrangement in the Mainland

The high-level comparison table below illustrates the key similarities and differences between chapter 15 in the U.S. (which enacted the Model Law without any material deviations) and the Mainland recognition and assistance regime under the Cooperation Arrangement (according to the terms of the SPC Opinion):

	Chapter 15	Cooperation Arrangement
Proceedings that can be recognized	"Foreign proceedings," being judicial or administrative proceedings in a foreign country under a law relating to insolvency or adjustment of debt in which the debtor's assets and affairs are subject to control or supervision by a foreign court for the purpose of reorganization or liquidation.	Hong Kong collective insolvency proceedings, including: • Compulsory winding up • Creditors' voluntary winding up • Schemes of arrangement for restructuring debt, promoted by a liquidator or provisional liquidator and sanctioned by the Hong Kong court.
Representatives that can be recognized	"Foreign representative," being a person or entity authorized in the foreign proceeding to	A liquidator or provisional liquidator appointed by the Hong Kong court.

	Chapter 15	Cooperation Arrangement
	administer the reorganization or liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding.	
Jurisdiction	Debtor has its: • center of main interests ("COMI") or • an establishment (being a place where the debtor carries out non-transitory economic activity) in the place where the foreign proceedings sought to be recognized have been commenced.	Debtor has its: • COMI in Hong Kong. • Principal assets, a place of business or a representative office in Shenzhen, Shanghai or Xiamen.
Date at which COMI is determined	The date of the filing of the chapter 15 petition, although a U.S. Bankruptcy Court can examine the period between the initiation of the foreign proceeding and the filing of the chapter 15 petition to ensure that COMI has not been manipulated.	At least six months prior to the commencement of the recognition application.
Notice to creditors/interested parties of recognition application	At least 21 days' notice of the hearing (unless shortened by the court).	Five days' notice (creditors then have seven days to object).
Interim relief	Yes—on application (from the time of filing a petition for recognition until the court rules on the petition) where relief is urgently needed to protect the assets of the debtor or the interests of the creditors. Such relief can include: • Staying execution against the debtor's assets. • Entrusting the administration or	Yes—on application, preservation measures are available in accordance with Mainland law from the time of receipt of an application for recognition and assistance until such application is determined.

	Chapter 15	Cooperation Arrangement
	realization of all or part of the debtor's assets located in the U.S. to the foreign representative in order to protect and preserve the value of assets that are perishable, susceptible to devaluation or otherwise in jeopardy. • Suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor. • Providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities. • Granting any additional relief that may be available to a trustee.	
Automatic relief on recognition	Recognition of a foreign proceeding commenced in the jurisdiction of the debtor company's COMI (i.e., a foreign main proceeding) automatically triggers certain provisions of the U.S. Bankruptcy Code, including: • Stay on the commencement or continuation of judicial, administrative or other action or proceeding against the debtor company in the U.S. • Stay on the enforcement of a judgement against the debtor or against its property in the U.S. • Stay on the creation, perfection or enforcement of any lien against the	Yes, relief includes: • Invalidation of payment of debts to individual creditors. • Suspension of civil actions or arbitration proceedings that have not been concluded (although these can be recommenced after the Hong Kong insolvency officeholder takes possession of the debtor company's property). • Lifting any preservation measures in respect of the property of the debtor company.

	Chapter 15	Cooperation Arrangement
	property of the debtor in the U.S. • Others, such as use, sale or lease of property under section 363, voiding certain pre-petition transactions, restricting certain post-petition transactions. No automatic relief is available upon recognition of a foreign proceeding commenced in a jurisdiction where the debtor company only has an "establishment" (i.e., a foreign non-main proceeding).	
Additional relief on application	Yes, where necessary to effectuate the purpose of chapter 15 recognition and to protect the assets of the debtor or the interests of the creditors, including: • Staying the commencement or continuation of an individual action or proceeding concerning the debtor's assets, rights, obligations or liabilities. • Staying execution against the debtor's assets. • Suspending the right to transfer, encumber or otherwise dispose of any assets of the debtor. • Providing for the examination of witnesses, the taking of evidence or the delivery of information concerning the debtor's assets, affairs, rights, obligations or liabilities. • Entrusting the administration or	Yes—on application, the relevant Pilot Court can grant assistance concerning the realization of bankruptcy property, distribution of bankruptcy property, debt restructuring arrangements or termination of bankruptcy proceedings, including to empower the Hong Kong insolvency officeholder to: • Take possession of property, seals, account books, documents and other data of the debtor. • Investigate the financial position of the debtor and prepare a report on that topic. • Decide matters relating to the debtor's internal management. • Decide matters relating to day-to-day expenses and other necessary expenditure. • Before the holding of the first creditors' meeting,

	Chapter 15	Cooperation Arrangement
	realization of all or part of the debtor's assets within the territorial jurisdiction of the U.S. to the foreign representative or another person, including an examiner, authorized by the court. This relief applies to both foreign main or non-main proceedings.	decide whether to continue or suspend the business of the debtor. • Manage and dispose of the debtor's property. • Participate in legal actions, arbitrations or any other legal proceedings on behalf of the debtor. • Accept the declaration of claims by creditors in the Mainland and examine them. • Perform any other duties that a Pilot Court allows. The Hong Kong insolvency officeholder shall not perform duties beyond the scope provided by the EBL and by Hong Kong law.
Protection of creditors	• Courts may grant relief only if the interests of the creditors and other interested entities, including the debtor, are sufficiently protected. • Before granting relief, the court will generally focus on the procedural fairness of the foreign proceeding and whether U.S. creditors are entitled to equal treatment in the foreign proceeding.	Any act by Hong Kong insolvency officeholder that involves a waiver of property rights, creation of security on property, loan, transfer of property out of the Mainland and other acts for the disposal of property that has a major impact on creditors' interests requires separate approval by the relevant Pilot Court.
Grounds for refusal of recognition	• If recognition would be manifestly contrary to the public policy of the U.S. • If there is insufficient evidence to support a finding that the debtor has its COMI or an establishment in the	Where the Pilot Court is satisfied that: • The debtor company's COMI is not in Hong Kong or has been in Hong Kong for less than six months. • Article 2 of the EBL is not satisfied[4].

	Chapter 15	Cooperation Arrangement
	place of the foreign proceeding.	• Mainland creditors are treated unfairly. • Fraud. • Violates the basic principles of Mainland law. • Offends public order or good morals. • Any other circumstance where the Mainland court considers that recognition or assistance should not be granted.
Cross-border judicial cooperation	The court shall cooperate to the maximum extent possible with a foreign court or a foreign representative.	The Pilot Courts shall actively communicate and take forward cooperation with the Hong Kong Companies Court.
Distributions to creditors under a restructuring plan	Distribution to creditors does not need to replicate the priority order established by the U.S. Bankruptcy Code; rather, it should be similar to such priority order and have a reasonable basis.	Property of the debtor in the Mainland must first be used to satisfy preferential claims in the Mainland[5]. The remainder of the property is to be distributed in accordance with the Hong Kong insolvency proceedings, provided that creditors in the same class are treated equally.

As noted above, the Cooperation Arrangement differs from chapter 15 and the Model Law in several material respects. Some of these key differences and the potential ramifications of such differences are outlined below:

1. Applicable Foreign Proceedings and Foreign Representatives

Under chapter 15, the U.S. Bankruptcy Court may recognize "foreign proceedings," which is defined broadly to mean "judicial or administrative proceedings in a foreign country under a law relating to insolvency or adjustment of debt in which proceeding the debtor's assets and affairs are subject to control or supervision by a foreign court for the purpose of reorganization or liquidation." The U.S. Bankruptcy Court can also recognize and grant assistance to a "foreign representative," being a person or entity authorized in the foreign proceeding to administer the reorganization or liquidation of the debtor's assets or affairs or to act as a representative of such foreign proceeding.

In practice, chapter 15 has been used to recognize a wide range of insolvency and restructuring procedures in numerous jurisdictions, including schemes of arrangement that have been proposed outside of a liquidation or provisional liquidation. Similarly, a "foreign representative" need not be an insolvency officer appointed by the foreign

court. The foreign representative could be, for example, a chief restructuring officer or chairperson or board member that is authorized on behalf of the company to pursue the restructuring or insolvency proceeding.

In contrast, the scope of applicable Hong Kong proceedings and foreign representatives that may be recognized in the Mainland under the Cooperation Arrangement is much narrower. The Pilot Courts may only recognize and grant assistance in respect of Hong Kong collective insolvency proceedings—being compulsory winding up, creditors' voluntary winding up and schemes of arrangement for restructuring debt that are promoted by a liquidator or provisional liquidator and sanctioned by the Hong Kong court.

As matters currently stand, the decision to restrict recognition and assistance to schemes of arrangement only when they are promoted by a provisional liquidator or liquidator will limit the use of the Cooperation Arrangement in the context of consensual restructurings in Hong Kong. Ideally, consensual restructurings are implemented without the appointment of a liquidator or provisional liquidator wherever feasible, as such appointments can trigger significant adverse consequences for the debtor and its business (including with respect to the status of its listing on the Stock Exchange of Hong Kong (the "HKEx") and its banking arrangements).

The inclusion of a mechanism to enable the recognition in the Mainland of a Hong Kong scheme of arrangement proposed outside of a liquidation or provisional liquidation process would have been beneficial, as it would more readily have facilitated the implementation of consensual restructurings in Hong Kong by ensuring that dissenting scheme creditors in the Mainland are effectively prevented from taking steps in the Mainland in contravention of a Hong Kong scheme. If such protection is required, it will be necessary to take steps to appoint a liquidator or provisional liquidator in Hong Kong before the scheme is proposed so that an application for recognition can be made under the Cooperation Arrangement.

2. COMI

Chapter 15 provides for the recognition of insolvency proceedings as "foreign main proceedings" that are commenced in the jurisdiction where the debtor's COMI is located. As noted in the table above, upon recognition of foreign main proceedings, certain automatic relief under the U.S. Bankruptcy Code is triggered, including a stay on the commencement or continuation of proceedings in the U.S., and a wide range of additional relief can be granted by the court in such circumstances.

In addition, where an insolvency proceeding has been commenced in a place where the debtor does not have its COMI but has sufficient "non-transitory economic activity" to give rise to an "establishment," the proceedings can be recognized as "foreign non-main proceedings". Although recognition as a "foreign non-main proceeding" will not trigger automatic relief, the U.S. Bankruptcy Court has broad discretion to grant a wide range of specific relief, including a stay of particular proceedings.

In contrast, under the Cooperation Arrangement, Hong Kong insolvency proceedings can only be recognized in the Mainland and relief and assistance granted if the relevant debtor company has its COMI in Hong Kong. There is no scope to recognize Hong Kong proceedings as "foreign non-main proceedings" as contemplated under the Model Law. Proving the existence of COMI in Hong Kong will therefore be vital in future Mainland recognition applications.

The SPC Opinion provides that COMI generally means the debtor's place of incorporation, although the Pilot Courts may have regard to other factors including the place of the debtor's principal office, the debtor's principal place of business and place of principal assets. This indicates that the Pilot Courts may follow a similar approach to the Model Law in the determination of COMI in that the presumption that COMI is in the place of incorporation can be rebutted by the presence of other factors.

According to the HKEx website, as of December 31, 2020, there were 1,319 Mainland enterprises listed on the HKEx, comprising 52 percent of the total number of companies listed and 80 percent of the total market capitalization. Many of these companies are incorporated outside of Hong Kong and have issued substantial foreign debt. Whether or not the regime will have broad relevance and application to HKEx-listed Chinese corporate groups will therefore depend upon the Pilot Courts' approach to the determination of COMI. If too narrow an approach is adopted, this may limit the utility of the Cooperation Arrangement for HKEx-listed Chinese groups.

Under the Cooperation Arrangement, COMI must have been in Hong Kong for at least six months prior to the date of the application for recognition. This is a departure from the approach of the courts in a number of Model Law countries. For example, in the U.S. and Singapore, the COMI of a debtor company is determined as of the date of the petition for recognition[6], whereas in Australia, COMI is assessed as of the date of the hearing of the recognition application. In England, COMI is assessed as of the date on which the request to open insolvency proceedings is made.

An assessment of COMI at a relatively late stage in a number of jurisdictions has enabled debtors to take steps to shift COMI to a particular jurisdiction in order to avail themselves of the restructuring regime in that jurisdiction and then they have benefited from recognition of those proceedings by other relevant courts. Although it is not yet clear whether the Pilot Courts will permit COMI shifts, the six-month requirement under the Cooperation Arrangement for the existence of COMI will, without significant forward planning, make it more difficult in practice for debtors to implement a COMI shift to Hong Kong in order to commence liquidation or provisional liquidation proceedings there and then avail themselves of the Cooperation Arrangement. Debtor companies that anticipate a future need to utilize the Cooperation Arrangement should therefore seek early advice on whether they have a sufficient nexus to Hong Kong to enable the COMI test to be satisfied and assess whether any adjustments to their existing structure and operations are required.

3. Judicial Discretion

As noted in the table above, under chapter 15, the U.S. Bankruptcy Court may refuse to grant recognition if it would be manifestly contrary to the public policy of the U.S.. U.S. Bankruptcy Courts invoke this provision of chapter 15 in exceptionally rare circumstances and, when they do, the evidentiary burden that must be overcome is very high. The analysis will generally focus on two key factors: whether the foreign proceeding is procedurally unfair and whether recognizing it would impair a U.S. statutory or constitutional right. Only twice has a U.S. Bankruptcy Court refused to recognize a foreign proceeding based on the public policy exception[7]. The public policy exception may also be invoked in the context of a foreign representative seeking specific relief from the U.S. Bankruptcy Court subsequent to recognition and, in this context as well, the exception is rarely granted and the evidentiary burden is high.

In contrast, under the Cooperation Arrangement, there are multiple grounds upon which the Pilot Courts can refuse to recognize a Hong Kong insolvency proceeding or assist a Hong Kong insolvency officeholder. This includes the potentially very wide-ranging and varying situations where, on evidence adduced by an interested party, "there is any other circumstance where the Pilot Court considers that recognition or assistance should not be granted." Similarly, the SPC Opinion provides that the Pilot Courts may modify or terminate any recognition or assistance upon discovering any circumstances that may impact the recognition of and assistance to the Hong Kong insolvency proceedings.

The Mainland therefore has reserved significant flexibility to decide whether recognition and assistance in any particular situation will be granted or maintained. Offshore investors and the restructuring community will be watching to see in practice the extent to which these grounds for refusal will be utilized as test cases emerge.

A Welcome Development for Hong Kong Insolvency Officeholders and Offshore Creditors

Although we will need to see how the Cooperation Arrangement is applied in practice, many market participants will no doubt welcome the broad relief and assistance that has now been made available in the Mainland to provisional liquidators or liquidators appointed in Hong Kong.

When enforcing their rights following a debt default, a key remedy for offshore creditors of HKEx-listed Mainland Chinese groups has been to apply to appoint a liquidator or provisional liquidator in the offshore jurisdiction or Hong Kong over the offshore incorporated debtor that issued the foreign debt. However, this is just the first step in the path to recovery for offshore creditors. If all of the group's value sits onshore in the Mainland, the liquidators or provisional liquidators need to be able to quickly and effectively take steps in the Mainland to preserve and realize that value onshore.

Where the debtor has a sufficient jurisdictional nexus to Shenzhen, Shanghai or Xiamen and has its COMI in Hong Kong, a liquidator or provisional liquidator appointed in Hong Kong will have an advantage over liquidators or provisional liquidators appointed in other jurisdictions. In the context of Chinese group failures, this may lead to more winding-up petitions being presented in Hong Kong compared with the relevant offshore jurisdictions—a new direction that was signaled in the recent landmark Hong Kong court decision in *Re Lamtex*[8]. As we explained in our recent Client Alert, in that case the Hong Kong Companies Court gave primacy to a winding-up petition in Hong Kong (where the company's COMI was located) over a provisional liquidation application in Bermuda where the company was incorporated.

Some examples of how Hong Kong insolvency officeholders might seek to use the Cooperation Arrangement in practice include:

- Seeking interim relief in the Mainland to prevent hostile onshore management from taking steps to frustrate the ability of the Hong Kong insolvency officeholders to realize and/or take control of the shares held by the offshore debtor in Mainland incorporated subsidiaries.
- Pursuing and preserving intercompany or other claims that the offshore debtor may have against Mainland incorporated subsidiaries.

- Facilitating access to bank accounts and funds of the offshore debtor that are located in the Mainland.
- Safeguarding the books and records of the offshore debtor in the Mainland.
- Seeking assistance from the Pilot Courts in respect of the examination of directors and officers of the offshore debtor who reside in the Mainland for the purposes of investigating the business and affairs of the debtor and the conduct of its directors and officers.
- Seeking to have an administrator appointed in the Mainland to provide assistance.

These powers will arguably enhance the leverage of Hong Kong insolvency officeholders and offshore creditors in relevant Mainland Chinese group situations. That is not to say, however, that the Cooperation Arrangement will counteract all of the risks and challenges for offshore creditors of investing in structurally subordinated debt issued by Mainland Chinese corporate groups. Fundamentally, the recovery to offshore creditors will be impacted by a variety of factors, including what action structurally senior onshore creditors take in the Mainland to enforce their rights and whether or not the onshore subsidiaries become subject to a Mainland bankruptcy process under the EBL.

Nevertheless, the Cooperation Arrangement is a significant step forward for cross-border insolvency and restructuring in the Mainland and Hong Kong and further reinforces Hong Kong's position as a major financial center and important gateway to the Mainland. It will also further enhance and complement the existing suite of mutual assistance treaties between Hong Kong and the Mainland in non-insolvency matters.

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[1] https://uncitral.un.org/en/texts/insolvency/modellaw/cross-border_insolvency/status

[2] [2020] 1 HKLRD 676.

[3] [2020] HKCFI 965.

[4] Article 2 of the EBL provides that a company can only be liquidated or reorganized under the EBL where it cannot pay its debts when due and its assets are not sufficient to pay all of its debts or where it appears to lack (or, in the case of a reorganization, has forfeited) the ability to pay its debts.

[5] Preferential claims include (in addition to the costs and expenses of the bankruptcy proceedings) certain employee claims, social insurance premiums and taxes.

[6] Subject to the ability of the U.S. Bankruptcy court to examine the period between the initiation of the foreign proceeding and the filing of the chapter 15 petition to ensure that COMI has not been manipulated.

[7] *In re Toft*, 453 B.R. 186 (Bankr. S.D.N.Y. 2011) and *In re Gold & Honey, Ltd.,* 410 B.R. 357 (Bankr. E.D.N.Y. 2009).

[8] [2021] HKCFI 651.