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**In a Landmark Ruling,
Shanghai Financial Court
Recognizes Judgment
Made by Hong Kong
Court Regarding a
Keepwell Deed**

Authors:



Rock Wang
Partner, Fangda Partners
rock.wang@fangdalaw.com



Joyce Zhou
Partner, Fangda Partners
joyce.zhou@fangdalaw.com



Guanbing Chen
Counsel, Fangda Partners
guanbing.chen@fangdalaw.com



Jenny Ding
Associate, Fangda Partners
jenny.ding@fangdalaw.com

Recently on 16 November 2020, the Shanghai Financial Court announced that they issued a decision (“**Decision**”) recognizing a Hong Kong court’s judgment ordering the HX Group to honor legal liabilities under a so-called “keepwell” agreement. Keepwell agreements, sometimes known as “gentlemen’s agreements”, have been widely used in PRC companies’ offshore bond issuances or debt arrangements for several years as a means of providing credit enhancement. Under a keepwell arrangement, a PRC enterprise undertakes to ensure that its offshore subsidiary (i.e. the borrower or the issuer) will maintain certain liquidity or net assets, and to ensure the repayment of principal and interest by injecting capital, or providing additional working capital to, the offshore subsidiary should be faced with financial distress.

Uncertainties surrounded the enforceability of keepwell agreements earlier this year after the administrator of the Peking University Founder Group Corp. (“**Founder Group**”) denied the creditors’ rights under the Founder Group’s keepwell arrangement.¹ This is, therefore, a very important decision, indicating the Chinese courts’ willingness to enforce keepwell agreements and, in so doing, providing reassurance to offshore creditors that lend to PRC companies. As it has been reported that the HX Group has entered into bankruptcy proceedings, we can reasonably expect the administrator of the HX Group to recognize creditors’ rights against the HX Group following the Decision.

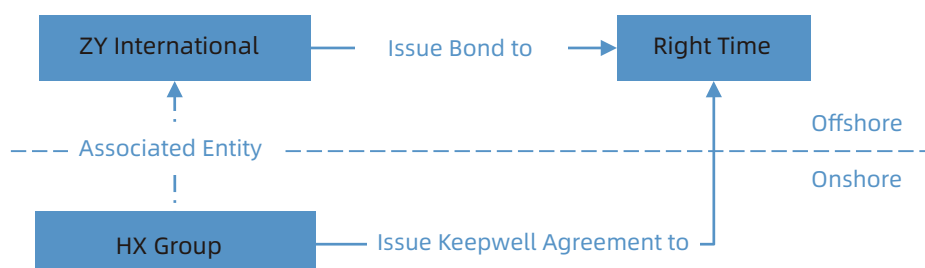
This article explains the Decision and offers some pointers to offshore creditors on how best to protect their interests once they have entered into keepwell agreements.

Background to the Judgment

ZY International, a company incorporated in the British Virgin Islands, is an associated entity of HX Group. ZY International issued a €29.9 million (“**ZY Bond**”) on October 23, 2017; on the same day, HX Group entered into a keepwell agreement (the “**HX Keepwell Agreement**”) with the registered bondholder of the ZY Bond, Right Time Global Investment SPC-Right Time Value Investment Fund SP (“**Right Time**”).

Pursuant to the HX Keepwell Agreement:

- HX Group undertook to take steps to safeguard the interests of Right Time by ensuring ZY International would maintain its consolidated net assets and have access to sufficient liquidity
- While the HX Keepwell Agreement does not constitute a guarantee, HX Group agreed to bear any legal liabilities should ZY International fail to perform its obligations
- The HX Keepwell Agreement was governed by UK law, and the courts of Hong Kong had jurisdiction to settle any disputes arising under the HX Keepwell Agreement.



1. See "Founder Group Refused to Confirm US\$1.7 Billion Debt, Concerns are Growing about the Risk of Keepwell Agreements" at <https://www.yicai.com/news/100766485.html>

On July 24, 2018, Right Time initiated a lawsuit against HX Group in connection with the HX Keepwell Agreement in the Court of First Instance of the High Court of Hong Kong. Subsequently, a default judgment was made against HX Group ("**HK Judgment**"), according to which HX Group was ordered to pay Right Time the principal of the ZY Bond, interest, and other fees. In May 2019, Right Time applied to the Shanghai Financial Court for recognition and enforcement of the HK Judgment and recently obtained the Shanghai court's decision in its favor.

Court's Opinion – Focus on Procedure Rather than Substantive Review

The Shanghai court decided that a final judgment with force for enforcement made by a Hong Kong court should be recognized and enforced by the mainland court, unless there are any circumstances listed in Article 9 of the *Arrangement of the Supreme People's Court between the Mainland and the HKSAR on Reciprocal Recognition and Enforcement of the Decisions of Civil and Commercial Cases under Consensual Jurisdiction* ("**Arrangement**"). For example, this might be if the procedure is flawed, or if the judgment was obtained by fraudulent means, or if enforcing the Hong Kong court's judgment is deemed to be against the mainland's public interest.

During the hearing, the HX Group raised three grounds for defense: (i) the jurisdiction agreement was invalid; (ii) HX Group was not correctly summoned in accordance with the law and the Hong Kong judgment was obtained by fraudulent means; and (iii) enforcing the Hong Kong court judgment was against the mainland's public interest.

In particular, in regard to the defense (iii), the HX Group maintained that, despite what was stated in the HX Keepwell Agreement, it actually amounted to a guarantee; since this guarantee had not been examined and approved by the State Administration of Foreign Exchange, enforcing the Hong Kong judgment was against the public interest of the mainland.

The Shanghai rejected this argument and held that public interest of the mainland defense did not apply because:

- The recognition and enforcement of a judgment made by a Hong Kong court does not involve the interests of a non-specified majority in the mainland
- The Hong Kong judgment in default did not violate due process
- The HX Keepwell Agreement is governed by the laws of UK, and therefore the substantive laws of the mainland China should not be applied to interpret the nature and validity of the HX Keepwell Agreement. The only criterion that applied was whether the result of recognition and enforcement would be against the mainland's public interest but the HX Group failed to prove that the relevant recognition and enforcement would be against the mainland's public interest.

The Shanghai Financial Court further said that it was only concerned with whether there had been procedural flaws; it said the effectiveness of the HX Keepwell Agreement under the mainland laws are not within the review scope of Shanghai Financial Court in this case.

So far as the HX Group's defenses of "invalid jurisdiction agreement", "without legal summons" and "obtaining the judgment by means of fraudulence" were concerned, the Shanghai Financial Court rejected all of these defenses in light of the applicable Hong Kong laws and the ascertained facts.

In summary, the Shanghai Financial Court held that there were no circumstances under Article 9 of the Arrangement that applied and it therefore made the decision to recognize and enforce the HK Judgment.

How Should Creditors Protect Themselves?

Just like the measures to safeguard and realize creditors' rights under keepwell arrangements covered in our previous article², the HX Group case provides a proven feasible path for offshore creditors' relief under keepwell agreements. That is: if the keepwell agreement stipulates that the governing law is a foreign law and the jurisdiction is outside the mainland, after a favorable judgment or arbitration award has been obtained offshore, the creditors are able to apply to a mainland court for recognition and enforcement on the basis of reciprocity, bilateral agreements or the New York Convention.

Additionally, we highlight two important points which offshore creditors should be aware of in order to protect their interests when relying on keepwell arrangements:

Respond quickly: As soon as creditors become aware of debtors having difficulty meeting their obligations, or in the event of default, creditors should as soon as practicably possible begin legal enforcement actions outside the mainland jurisdiction.

We saw this in the HX Group case: Right Time initiated a lawsuit in the Hong Kong court and obtained an effective Hong Kong judgment as early as 2018. The Shanghai Financial Court reviewed the application for recognition and enforcement of HK Judgment submitted by Right Time in May 2019. Yet, it was only recently that the court made the Decision. From this, it can be noted that it may take a long period of time to secure recognition and enforcement.

Another reason for acting quickly is to avoid the situation where the creditor may be prevented from pursuing a case outside the mainland should the keepwell provider enter into bankruptcy proceedings. The relevant law here is the *Enterprise Bankruptcy Law of the People's Republic of China*, which specifies that a lawsuit regarding confirmation of a creditor's rights in an insolvency has to be filed in the specific court accepting the application for bankruptcy. There may be doubts whether a judgment made outside the mainland is capable of being recognized by a mainland court if the creditors initiate the lawsuit outside the mainland after the keepwell provider has entered into bankruptcy proceedings. If the offshore creditors in the Founder Group case file a lawsuit with a court outside the mainland, the effectiveness of the abovementioned criteria is expected to be further tested.

Ensure comprehensive contractual arrangements: Clear and comprehensive contractual arrangements in the keepwell agreement may reduce the uncertainty and confusion of the court or the administrator. There should be specific provisions dealing with default liability (such as liquidated damages or compensation to the creditors), which will help creditors to protect their rights.

2. See "Keepwell Arrangement Faces Test Amid Insolvency and Restructuring Process" at <https://www.linkedin.com/feed/update/urn:li:activity:6674258580318900225>

Taking the Founder Group's keepwell arrangement as an example, the Founder Group undertook to purchase the equity interest held by the guarantor and/or any other overseas subsidiary of Founder Group, thus creating a means to repay the offshore debt by using the onshore parent's funds if and when an event of default occurs (subject, however, to obtaining all necessary approvals, consents, licenses, orders, permits and any other authorizations from the relevant authorities). In the HX Group Case, the HX Keepwell Agreement included default penalty clauses, providing Right Time with clear contractual basis on which to claim.

Conclusion

The recognition of the Hong Kong judgment between Right Time and HX Group by the Shanghai Financial Court will be great news for a large number of holders of keepwell-backed bonds and should go a long way to restoring offshore creditors' confidence when lending to offshore associated entities of PRC companies.

The case also sends a strong signal about the openness of Shanghai's judicial environment, as well as reinforcing the reputation of the Shanghai as international financial center.

Beijing

27/F, North Tower
Beijing Kerry Centre
1 Guanghua Road
Chaoyang District
Beijing 100020, China

Tel: +86 10 5769 5600
Fax: +86 10 5769 5788

Guangzhou

17/F, International Finance
Place, 8 Huaxia Road,
Zhujiang New Town
Guangzhou 510623, China

Tel: +86 20 3225 3888
Fax: +86 20 3225 3899

Hong Kong

26/F, One Exchange Square
8 Connaught Place, Central
Hong Kong

Tel: +852 3976 8888
Fax: +852 2110 4285

Shanghai

24/F, HKRI Centre Two,
HKRI Taikoo Hui
288 Shi Men Yi Road
Shanghai 200041, China

Tel: +86 21 2208 1166
Fax: +86 21 5298 5599

Shenzhen

17/F, Tower One, Kerry Plaza
1 Zhong Xin Si Road
Futian District
Shenzhen 518048, China

Tel: +86 755 8159 3999
Fax: +86 755 8159 3900