WELL KEPT BUT TIMED OUT? RECENT HONG KONG COURT DECISIONS SHOW TIMING IS EVERYTHING IN ENFORCEMENT OF BONDHOLDER RIGHTS



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Two recent Hong Kong decisions by the Hong Kong court have brought mixed messages for holders of offshore Chinese bonds structured through keepwell arrangements. On the one hand, the decisions concerning Peking University Founder Group Limited (PUFG) and Tsinghua Unigroup may give confidence that bondholder rights are, in principle, enforceable in Hong Kong. On the other, the Hong Kong court has laid down a strict test as to the window of time during which bondholders can hold issuers accountable and have their claims recognised by the courts in the mainland.

Both Tsinghua and PUFG had been undergoing restructuring of their onshore and offshore debts in the PRC mainland. Administrators there had either rejected the claims or not responded to the proofs of debt lodged on behalf of holders who had the benefit of a keepwell agreement.

A particular structure

Keepwell agreements are a particular feature of the China onshore / offshore credit market, under which the mainland parent company undertakes to maintain the solvency of a subsidiary when the subsidiary issues offshore bonds, without a formal guarantee of repayment in the event of default.

The deeds are typically governed by English law and include Hong Kong exclusive jurisdiction clauses. The bond issuer may not itself have assets or cash flow and so will require assistance from its group in order to service the bond. By adding a level of credit enhancement, the bond becomes more attractive to investors who are given cause to expect that the issuer will meet its obligations in a timely fashion. A complication arises in that approval is generally required from the mainland authorities before funds can be remitted out of the mainland.

In the case of Tsinghua, the plaintiff claimed for the defendant's breach of contractual obligations owed to it under a keepwell deed and equity interest purchase undertaking (EIPU) in respect of US$450,000,000 six per cent Guaranteed Bonds due in 2020, issued by Unigroup International Holdings Ltd (the issuer) and guaranteed by Tsinghua Unigroup International Co Ltd (the guarantor).

The plaintiff argued that pursuant to the keepwell deed and the EIPU, the guarantor and issuer were required to have sufficient liquidity and/or means to comply with their obligations in respect of the bonds at all times. The plaintiff claimed the defendant failed to perform its obligations and was thus liable to the plaintiff for damages. Harris J found the defendant to be in breach and ordered the group to pay to the bond trustee US$483.8 million made up of the face value of the bonds, interest and costs.

Harris J said there was no evidence of the company, the issuer or the guarantor ever making any efforts to comply with its keepwell or EIPU obligations "or, for that matter, giving any consideration to how they might do so". The breaches occurred in December 2020, well before the onshore reorganisation process commenced in July 2021.

The defendant "did not formulate a plan to ensure that the finance required by the Keepwell Deed was provided to the Issuer or Guarantor in 2020 and never explored with the Approval Authorities whether whatever consents were required were likely to be given".

That ruling came just weeks after the decision in the PUFG litigation. PUFG had entered into keepwell agreements with two bond-issuing subsidiaries, Nuoxi Capital Limited (Nuoxi) and Kunzhi Limited (Kunzhi) (the issuers) within the Peking University Group, their two Hong Kong-incorporated direct parents, who had guaranteed the issuers' obligations under the bonds (the guarantors), and the bond trustee.

Kunzhi was a wholly owned subsidiary of Founder Information (Hong Kong) Limited (FIHK), which pursuant to the trust deeds to which it was also a party, guaranteed Kunzhi's obligations under the bonds issued by Kunzhi. The bonds in question were issued in April and May 2018, amounting to a total value of approximately US$1.7 billion.

The keepwell agreements contained identical material terms, which required PUFG to cause each of the issuers and guarantors to have sufficient liquidity to ensure timely payment of any amounts payable under the bonds.

Harris J took the view that there was a "material difference" between what the company had to show in respect of a failure to comply with the keepwell agreements or the EIPUs before the reorganisation commenced on 19 February 2020 and after it had commenced.

Harris J commented that "once the Company was in reorganisation there was no realistic likelihood of approvals being given to transfers out of the Mainland. This would simply have depleted assets available to the

Administrators and the Company, which would otherwise be available to Mainland creditors or financing and implementing the reorganisation." This finding proved fatal to the claims in three out of the four actions.

Harris J found however that the position before the reorganisation took place, was different. He found that FIHK had a deficit of approximately US$167 million as at 31 December 2019. It therefore followed that PUFG "was in breach of the Keepwell Deed at that date and, presumably, for at least sometime before."

Harris J found that PUFG had taken "no steps at any time to obtain the approvals, consents, licences, orders, permits or any other authorisations as might prove necessary" for complying with PUFG's obligations under the keepwell agreements or under the EIPUs.

As such, PUFG "had failed to prove that it used its best efforts to obtain the necessary approvals and, as clearly it had not complied with its obligations under the Keepwell Deeds and the EIPUs", and consequently PUFG had breached its obligations. The decision is, however, presently being appealed.

A window closes

The lesson for offshore creditors is that they need to move swiftly before any PRC reorganisation proceedings get underway.

In the failed claims (which are subject to appeal), bondholders lost essentially as a matter of timing because the breaches came after the time that the entities entered their reorganisation processes onshore.

Securing the interests of bondholders requires swift and generally collective action to protect bondholders' rights. In the event of a threatened insolvency, bondholders representing at least 25 per cent of the amount of principal outstanding under the bond will need to act to instruct and usually indemnify and pre-fund a trustee to take steps to assert rights under a keepwell agreement.

Bondholders will need to satisfy themselves that they can effectively monitor the finance standing of their keepwell provider so they can move quickly in the event of a potential breach. It appears the terms of future keepwell agreements (to the extent they continue to be used) could be improved upon to allow for improved monitoring of covenants and greater financial reporting to signal warnings on the provider's solvency before it is too late. But by then, the whole notion of the keepwell bond may be seen as something of a bull market relic.

*Hogan Lovells represented Citicorp in the Tsinghua proceedings.