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IMPACT OF ARBITRATION CLAUSES ON INSOLVENCY PROCEEDINGS: A RETREAT FROM THE LASMOS APPROACH?

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SUMMARY

Recent Hong Kong cases have highlighted varying approaches regarding the impact of arbitration clauses on insolvency proceedings, in particular, on the Court's discretion to make a winding-up order where a debt is disputed.

Recent judgments have varied between the so-called Traditional Approach which requires the company-debtor to show a genuine dispute on substantial grounds and the *Lasmos* Approach which requires the company only to commence arbitration in a timely manner.

THE TRADITIONAL APPROACH

Under the Traditional Approach, the courts have applied different tests depending on whether the winding-up petition was made on the grounds of insolvency or on just and equitable grounds.

If a creditor petitions to wind-up a company on the ground that the company-debtor has failed to satisfy a statutory demand, the Court should dismiss the winding-up petition if it is satisfied on evidence that the debt is genuinely disputed on substantial grounds (*Hollmet AG v Meridian Success Metal Supplies Ltd* [1997] 4 HKC 343). Usually it will not be sufficient for the company merely to deny or not admit the debt, or to show that there is an ongoing arbitration about the existence of the debt (*Re Sky Datamann (Hong Kong) Limited*, unrep., HCCW 487/2001).

In contrast, under a just and equitable winding-up petition, the test is whether the substance of the dispute between the shareholders is covered by the arbitration agreement (*Re Quicksilver Glorious Sun JV Ltd* [2014] 4 HKLRD 759).

THE *LASMOS* APPROACH

A different approach was adopted in the case of *Lasmos Limited v Southwest Pacific Bauxite (HK) Limited* [2018] HKCFI 426. In this case, the debt arose from a management services agreement in respect of management services provided by the creditor to a joint venture between the company-debtor and the creditor. The agreement provided for arbitration by the HKIAC.

On 24 July 2017, the creditor issued a statutory remand for unpaid management fees and petitioned to wind-up the company on 27 October 2017.

The HK Court of First Instance observed that, following the English Court of Appeal judgment in *Salford Estates (No 2) Ltd v Altormart Ltd (No 2)* [2015] Ch 589, the English and Singaporean courts have moved on from the Traditional Approach and adopted a more pro-arbitration approach. Departing from the Traditional Approach, Harris J held that the Court generally should dismiss the winding-up petition if the following criteria are satisfied:

1. the debt is disputed by the company;

2. the debt arises under a contract which contains an arbitration clause that covers any disputes relating to the debt; and

3. the company takes the steps required under the arbitration clause to commence the mandated dispute resolution process (which may include mediation), and files an affirmation to demonstrate this.

In exceptional circumstances, for example where there is a risk of dissipation of assets or other circumstances where the appointment of provisional liquidators may be justified, the Court may stay the winding-up petition instead of dismissing it.

Interestingly, in *obiter* comments, the Court in *Lasmos* observed that it would have dismissed the winding-up petition even if the Traditional Approach was to apply. The parties had never arrived at a binding agreement on the fees or the rate to be charged, and therefore there was no debt upon which a petition could be founded. Further, the statutory demand was invalid because a statutory demand could be served only in respect of a liquidated sum.

SUBSEQUENT COURT OF APPEAL DECISIONS

Lasmos (a 2018 decision) was considered a significant development in the law regarding the impact of arbitration clauses on insolvency proceedings.

The *Lasmos* Approach was subsequently considered by the HK Court of Appeal in two subsequent decisions, *But Ka Chon v Interactive Brokers LLC* [2019] HKCA 873 and *Sit Kwong Lam v Petrolimex Singapore Pte Ltd* [2019] HKCA 1220. In both cases, the debtor had not taken any steps to commence arbitration proceedings and, hence, failed to satisfy the criteria set out in *Lasmos*.

Notwithstanding that the appeals were dismissed, Kwan VP, who delivered the leading judgment in both *But* and *Sit*, made the following obiter observations on the *Lasmos* Approach:

1. In exercising its discretion to dismiss or stay winding-up proceedings, it is trite law that the court should consider all relevant circumstances, such as the financial position of the company, and the existence and positions of other creditors. In contrast, the *Lasmos* Approach requires the court to exercise its discretion in a one-way manner, namely to dismiss the petition save in exceptional circumstances, upon the satisfaction of certain criteria. Therefore, the *Lasmos* Approach represents a substantial curtailment of a creditor's statutory right to invoke the insolvency jurisdiction of the court, and is contrary to public policy.

2. Insolvency proceedings are not a means of enforcing a contract. It is a class remedy available to all of the creditors, and no adjudication to the parties' respective rights and liabilities as between themselves is made.

3. The court should give considerable weight to the arbitration factor in exercising its discretion. According to Kwan VP, pre-*Lasmos* authorities might have given insufficient weight to ongoing arbitration proceedings.

4. To invoke the *Lasmos* Approach, the company-debtor must demonstrate a genuine intention to arbitrate by taking the steps to commence the mandated dispute resolution process. Kwan VP further suggested that, even if the company-debtor does not have substantial counter-claims against the creditor, it should commence arbitration proceedings and seek a declaration of non-liability.

Although the HK Court of Appeal chose not to decide on the appropriateness of the *Lasmos* Approach, *But* and *Sit* have raised questions about the extent and application of the *Lasmos* Approach.

CRITICISM OF THE *LASMOS* APPROACH

In *Dayang (HK) Marine Shipping Co., Limited v Asia Master Logistic Limited* [2020] HKCFI 311, the company-debtor chartered a vessel from the creditor under a charterparty agreement which provided for arbitration in Hong Kong.

On 20 December 2018, the creditor issued a statutory demand for unpaid hire and petitioned to wind-up the company-debtor on 11 January 2019. On 22 February 2019, the company-debtor's solicitors sent a letter to the creditor's solicitors, stating that the company-debtor was prepared to resolve the disputes by arbitration butno further steps to commence arbitration proceedings were taken.

Applying the Traditional Approach, the Court held that the debt was not disputed in good faith on substantial grounds. In particular, the company-debtor's counterclaim was not substantiated by any

particulars and, upon examination, the company-debtor's allegations were contradicted by contemporaneous documentary evidence. Furthermore, because the company-debtor had not quantified its counterclaim, it could not argue that the counterclaim would exceed the debt and extinguish it.

Applying *But*, the Court in *Dayang* also found that the company-debtor did not meet the criteria in *Lasmos* because it had no real intention to resolve the dispute by arbitration. More specifically, the company-debtor had not taken any steps to commence arbitration after sending the letter about its professed desire for arbitration.

The judge devoted a significant portion of his judgment to an analysis of the different approaches adopted to the interaction between insolvency and arbitration proceedings before and after *Lasmos*.

Like the Court of Appeal in *But* and *Sit*, he questioned the appropriateness of ousting the Court's insolvency jurisdiction, and made *inter alia* the following comments on the *Lasmos* Approach:

1. In making a winding-up order, the Court does not make any determination of merits or resolve any dispute over the debt. Therefore, a petition to wind-up the company-debtor is not precluded by an arbitration clause which provides for the determination and resolution of the dispute by arbitration.

2. The creditor's right to petition should not be derailed by unmeritorious allegations as to the existence of a dispute. To the extent that some form of evaluation of merits is required, overseas authorities have failed to formulate a test that is different from the Traditional Approach in a meaningful way.

3. Even in cases where the debt is genuinely disputed on substantial grounds, the Court retains a wide discretion to proceed with the winding-up petition. By requiring the Court generally to dismiss the petition save in exceptional circumstances, the *Lasmos* Approach is inconsistent with the nature of the Court's discretion under *section 180(1)* of the *Companies (Winding Up and Miscellaneous Provisions) Ordinance*.

4. In cases where the company-debtor's assets are being dissipated, the requirement to show "*exceptional circumstances*" presents a very heavy obstacle to creditors. By the time the creditor establishes its debt through arbitration, it might be deprived of all tangible remedies. In that sense, the *Lasmos* Approach is prejudicial to the interest of creditors.

5. If a creditor uses insolvency proceedings to exert improper pressure on the company-debtor to obtain payment, it may constitute an abuse of process. Creditors who petition for the company-debtor's winding-up knowing that the underlying debt is genuinely disputed on substantial grounds may be liable to costs on an indemnity basis as well as damages for malicious presentation of the winding-up petition.

BCLP PERSPECTIVE

In *Dayang*, the Hong Kong court has drifted further from its counterparts in England and Singapore, which have embraced the *Salford* Approach (on which the *Lasmos* Approach is based) or a modified version of it.

It appears from recent cases that the Hong Kong courts are seeking to strike a balance between the creditor's statutory right to present a winding-up petition on grounds of insolvency and the parties' contractual bargain of referring disputes to arbitration. In particular, the approaches taken in *But*, *Sit* and *Dayang* may have set in motion the development of a moderate approach that reflects a compromise between the Traditional Approach and the *Lasmos* Approach.

KEY TAKEAWAYS

Until the HK Court of Appeal makes a clear ruling on the *Lasmos* Approach, creditors and debtors in Hong Kong should pay attention to the interaction between insolvency and arbitration proceedings, and take note of the following:

1. The existence of an arbitration agreement will be just one of the factors to be taken into account in the Court's exercise of the discretion to dismiss or stay a winding-up petition commenced on grounds of insolvency.

2. If the company-debtor has taken steps to commence arbitration, that is a factor that the court will take into account when considering whether the debt is genuinely disputed on substantial grounds. This may require the company-debtor to take pro-active steps to commence arbitration (e.g. by seeking a declaration of non-liability), rather than waiting for the creditor to commence an arbitration.

3. However, in all of the cases, including *Lasmos*, the Court made an independent finding as to whether the debt genuinely was disputed on substantial grounds. Therefore, the mere fact that steps have been taken to commence an arbitration may not be sufficient to persuade the Court to dismiss or stay the winding-up petition.

4. When drafting an arbitration clause, parties may choose expressly to limit the creditor's right to petition for winding-up prior to the commencement or completion of arbitration, but such agreements potentially might be unenforceable as being contrary to public policy (*Dayang* and *Sit*).

5. Creditors should not use winding-up proceedings as an improper means of exerting pressure to obtain payment of a disputed debt.

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