

A Step Closer to Legal Certainty for Holders of Chinese Keepwell-backed Bonds?

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It was reported on November 3, 2020, that the Shanghai Financial Court had recognized an August 2018 Hong Kong judgment, which ordered a Mainland Chinese company, CEFC Shanghai International Group Limited (“CEFC”), to pay a substantial amount to a noteholder on account of a so-called ‘keepwell’ deed. If the reporting is accurate (the Shanghai decision is not currently publicly available in written form), this is potentially a very noteworthy decision and a positive development for holders of keepwell-backed notes issued by Chinese groups. To put this in context, it has been estimated by Bloomberg that there is more than USD100 billion of outstanding Chinese offshore notes that are supported by keepwell arrangements.

In this high-level update, we look at the background and potential implications of this development.

What is a ‘Keepwell’?

Keepwell deeds and related arrangements are a form of credit enhancement for offshore debt issued by Chinese groups—typically high yield, USD denominated notes.

As we highlight below, ‘keepwells’ are not guarantees; in fact, they developed as a means for Chinese corporates to navigate a complex regulatory environment which made it challenging for them to guarantee or provide other forms of security in respect of offshore debt obligations.

While the terms of keepwells can vary, at their core they commonly involve an onshore group entity of substance undertaking, among other things, to provide financial support to the offshore issuer of the debt to maintain the issuer’s liquidity and solvency and enable the issuer to repay the notes. Other terms may include an undertaking requiring the onshore keepwell provider to continue holding a substantial interest in any offshore guarantor and/or to refrain from creating additional security to secure other offshore debt obligations. In this way, a keepwell has been characterized as a soft form of credit enhancement.

Spotlight on the Effectiveness of Keepwells

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Keepwells are not guarantees, nor do they provide for direct payment obligations of the keepwell provider to noteholders. The arrangements are generally foreign law governed and subject to the exclusive jurisdiction of courts outside Mainland China (e.g., in Hong Kong)—features that promote a degree of legal certainty.

However, a key question for noteholders and legal practitioners alike has always been how keepwells will hold up before Chinese courts in an enforcement scenario, bearing in mind keepwell providers are onshore entities subject to Chinese law, including, in an insolvency context, the Chinese Enterprise Bankruptcy Law.

Two developing Chinese corporate bankruptcies have recently been setting the scene for a decision relating to the enforceability of keepwells in China.

The first is the widely watched bankruptcy of Peking University Founder Group (“PKU Founder”), a large conglomerate with interests in software development, among other things.

A key focus of the market’s interest in this situation has been the treatment of PKU Founder keepwell-backed notes with a face value of more than USD1.7 billion. In August 2020, PKU Founder’s bankruptcy administrators rejected claims based on these keepwell notes (unlike claims based on guaranteed notes, which were accepted). The administrators’ decision was reportedly made on the basis that the effectiveness of keepwell arrangements had not been established in China. It was suggested that the note trustee obtain a judgment to confirm the arrangements.

Such a judgment already existed in relation to a different situation involving CEFC, a conglomerate involved in petroleum refining and infrastructure, among other things. Incidentally, CEFC’s bankruptcy gave rise to a significant decision of the Hong Kong Companies Court earlier this year when, for the first time, Mainland Chinese bankruptcy administrators were granted recognition and assistance in Hong Kong. This was an important milestone (since repeated) for increasing cross-border collaboration between Hong Kong and Mainland China in insolvency matters.

Back to the CEFC keepwell judgment, in July 2018, a holder of offshore notes issued by the CEFC group commenced proceedings in Hong Kong against CEFC for payment of the principal amount of the notes based on a keepwell deed entered into by CEFC (and/or damages for breach of the keepwell). On August 24, 2018, the plaintiff obtained a default judgment on its claim.

The Shanghai Financial Court Decision

Having obtained the Hong Kong judgment in August 2018, the plaintiff noteholder then sought to have the judgment recognized and enforced against the defendant, CEFC (the keepwell provider), in Mainland China.

This was made possible under a unique arrangement between Hong Kong and Mainland China—the *Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region* (the “Arrangement”)—which enables Hong Kong judgments to be recognized in the Mainland (and Mainland judgments to be recognized in Hong Kong) if they meet particular requirements, which were likely met in this case. Judgments given by most other foreign courts cannot currently be recognized in the same way.

As mentioned at the outset, recent reports suggest that the Shanghai Financial Court has now finally recognized the 2018 CEFC Hong Kong judgment. It seems that while the parties have been notified of this outcome, a written decision is not yet publicly available.

Greater Legal Certainty?

If the reports are accurate—and the Shanghai Financial Court’s decision will need to be studied carefully—this development marks a significant step forward in terms of establishing the preparedness of a Chinese court to uphold or recognize the effectiveness of keepwell obligations at the suit of a noteholder. The decision may become important in the context of future Chinese bankruptcies where keepwell obligations feature prominently.

At the same time, there are a number of countervailing points that need to be kept in mind, including the following:

1. There is no formal case law precedent system in China, albeit courts are increasingly paying greater attention to past decisions (which is demonstrated by the very recent issuance of the Supreme People’s Court *Guiding Opinion Concerning Strengthening Search for Similar Cases to Unify the Application of Law*). It remains the position in China that one judicial decision does not necessarily guarantee the same result in similar cases that follow it.
2. The CEFC Hong Kong judgment which has been reportedly recognized in China was a judgment in default (i.e., made without CEFC appearing in or defending the proceedings), so a future case where the keepwell arrangement is contested could potentially lead to a different outcome.
3. Finally, it is unclear to what extent public policy and other possible Chinese law issues that may be relevant to keepwell obligations were fully argued or considered in the CEFC context. Public policy is a prominent consideration in Chinese cases, and part of the mix of factors when the court is considering the recognition of a Hong Kong judgment under the Arrangement (which is expected to be replaced by a broader mutual recognition arrangement for judgments in civil and commercial matters that leaves equal room for argument on Chinese public policy grounds).

The upshot is that the Shanghai Financial Court decision is a welcome development for holders of keepwell-backed Chinese offshore notes and arguably enhances noteholder leverage. Noteholders will no doubt be watching this space very carefully both onshore and offshore as further keepwell enforcement scenarios and PRC bankruptcies arise, in order to assess the true implications of the decision for the keepwell-backed Chinese offshore bond market.

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