Asia Pacific Guide to Lending and Taking Security - Hong Kong SAR

If things go wrong

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# 1. Please provide a brief description of the insolvency regime. In particular what rights and duties do unsecured and secured lenders have on the insolvency of a debtor? Are there any other matters of concern?

Insolvency regime

There are three types of liquidation in Hong Kong: a members' voluntary liquidation, a creditors' voluntary liquidation and a compulsory liquidation.

A members' voluntary liquidation can be commenced only where the company is solvent. The directors must sign a certificate of solvency stating their opinion that the company will be able to pay its debts in full within a period not exceeding 12 months from the commencement of the winding-up. Then, the shareholders pass a special resolution to place the company into voluntary liquidation.

A creditors' voluntary liquidation occurs where the shareholders pass a special resolution to place the company into voluntary liquidation and where the directors have not signed a certificate of solvency. The resolution is usually passed on the basis that the company cannot continue its business because of its liabilities. A creditors' meeting is also required.

A compulsory liquidation occurs where a company is wound up by an order of the court. A company may be wound up by the court on a number of grounds, most often in an insolvency situation because it is unable to pay its debts. There is also a broad discretionary power under which the court can order a company to be wound up where it is just and equitable to do so. The application submitted to the court to wind up a company may be made by a creditor, a shareholder or the company itself. This is done by way of a winding-up petition.

Unsecured creditors

An unsecured creditor must prove its debts in a liquidation by submitting a proof of debt form to the liquidator.

After the liquidator has received all the proof of debt forms from the creditors, the liquidator will assess each of the claims and decide whether to admit each proof. If the liquidator considers a claim unenforceable, the liquidator can reject the claim and put the onus of proving the debt back on the creditor.

Assuming that there are sufficient assets available to enable the liquidator to make a distribution to the creditors of the company, the liquidator must make a distribution in accordance with the order prescribed by legislation. Generally, the order of distribution is as follows:

Secured creditors — assets of the company under security will be realized to pay off secured creditors first, with any excess proceeds distributed according to the subsequent priority below.

Expenses of the liquidation, including liquidator's fees.

Preferential payments (usually employees' wages and statutory debts due to the government).

Floating charge holders.

General unsecured creditors.

Members/shareholders of the company.

If there are insufficient assets to be distributed to pay a class of creditors in full, the general principle of *pari passu* distribution (i.e., all creditors of the same class rank equally in a winding-up) applies.

Statutory insolvency set-off applies to unsecured debts. Where before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company and any creditor of the company proving or claiming in the liquidation, an account must be taken of what is due from each party to the other and the sums due from one party are set off against the sums due from the other; only the balance can be proved in the liquidation. Statutory insolvency set-off is mandatory in a liquidation and it cannot be contracted out of.

Secured creditors

A secured creditor (e.g., a creditor holding a mortgage, charge or lien) is entitled to enforce its security despite the making of a winding-up order. It can rely on its security and need not prove in the liquidation if the security is worth the same as, or more than, the debt owed.

If the creditor is undersecured, it can realize the security and prove for any balance or waive the security and prove for the entire debt.

Guidelines issued by the HKMA and the Hong Kong Association of Banks

The HKMA and the Hong Kong Association of Banks have issued nonstatutory guidelines as in relation to how institutions should deal with borrowing customers in financial difficulties where the borrower is dealing with multiple banks. Banks are encouraged to opt first for a workout (a private contractual arrangement to assist a company in financial difficulty).

# 2. Is it possible to obtain a moratorium before insolvency?

There is no formal moratorium available to an insolvent company on the presentation of a winding-up petition. However, in practice, the period between the presentation of a winding-up petition and the creation of a winding up-order provides a moratorium period (otherwise unavailable under the current legislative regime) in which to conduct restructuring negotiations. The reason for this is that once a winding-up petition is presented, the insolvent company (and any creditor and person obliged to contribute to the assets of the company) can apply to the court for a stay of proceedings.

Once a winding-up order has been made or a provisional liquidator appointed, no action or proceeding can commence or continue except by leave of the court.

In 2020, the Hong Kong government announced its intention to introduce the Companies (Corporate Rescue) Bill ("**Bill**") in the Legislative Council at a date to be confirmed. The Bill was aimed at introducing a statutory corporate rescue procedure in Hong Kong, which would involve the appointment of an independent professional third party (a certified public accountant or solicitor) as a provisional supervisor of a company in financial difficulty. The provisional supervisor would displace the directors and management of the company and act as its agent during the period of provisional supervision (proposed to be set at 45 business days), during which the company would continue to operate as a going concern. There would be a moratorium on civil proceedings and actions against the company and its property during this period. As a protective measure for secured creditors, one of the proposed requirements to commence provisional supervision was that a person holding charges on the whole or substantially the whole of the company's properties (the major secured creditor) would not object to the provisional supervision within a specified period upon being notified of the provisional supervision. However, as of the date on which this guide has been published, the Bill had not yet been tabled in the Legislative Council.

It remains to be seen whether and, if so, in which form the Bill will be enacted and take effect.

# 3. When a company is the subject of a formal insolvency procedure, can the company’s pre-insolvency transactions be set aside?

Pre-insolvency transactions

Yes. In all forms of liquidation, a liquidator has the power to investigate the affairs of a company and seek redress from the court if it considers that assets belonging to the company have been dissipated. Some examples of possible areas that liquidators may investigate are set out below.

Unfair preference

A liquidator may challenge any creditor that received a payment from the company and may have been preferred against other creditors within six months of the commencement of the liquidation. The six-month period is extended to two years in the case of payments to a person connected with the company, which is broadly defined.

Disposition of property with the intent to defraud creditors

A disposition of property with the intent to defraud creditors is voidable at the behest of the person prejudiced by the disposition, except if the property has been disposed of for valuable consideration and in good faith to any person who has not been notified, at the time of the disposition, of the intent to defraud creditors.

Transactions at an undervalue

A court may set aside a transaction at an undervalue entered into within five years before the commencement of the liquidation. A transaction at an undervalue includes transactions that result in the company receiving consideration that is significantly less than the value provided by the company.

Disposition after the commencement of a compulsory liquidation

A disposition after the commencement of a compulsory liquidation is void and the recipients of these funds or assets must return them to the liquidator unless a validation order has been made by the court. A validation order is an order by which the court ratifies the relevant disposition of property.

Fraudulent trading

Where the business is carried on with the intent to defraud creditors or for any other fraudulent purpose, the persons who were knowingly parties to the carrying on of the business may be personally liable for the debts of the company.

Misfeasance

Where directors have breached their duties to the company or have misapplied or retained property of the company for their personal benefit, they may be ordered to repay or restore the money or property, or pay compensation to the company.

Insolvent trading

While fraudulent trading is prohibited, no legislation in Hong Kong prohibits insolvent trading or the incurring of a debt by a company at a time when it is unable to pay its debts as they fall due, although the liquidators may bring an action against the directors for the breach of their duties. The Hong Kong government is considering implementing provisions in relation to insolvent trading.

# 4. When can a lender enforce its security? Can security be enforced out of court following an event of default (or other contractual trigger event), or is a court order required? Are there any restrictions that apply before a lender may enforce its security?

Theoretically, a lender can enforce its security at any time; the precise time depends on the terms of the security document or other agreement between the lender and the borrower (e.g., as soon as the borrower is in default). However, the lender should give the debtor sufficient time to enable it to effect payment before enforcing the security.

Generally, there is no requirement to obtain a court order to enforce security. However, in respect of a mortgage over real property, a lender can bring a "mortgagee action" to obtain a court order for the payment of monies secured by the mortgage and for possession of the mortgaged property, among other things. Alternatively, a lender can enforce a mortgage by virtue of express or implied powers under the mortgage or powers implied into the mortgage by the Conveyancing and Property Ordinance.

Note that foreclosure of a mortgage (i.e., extinguishing a mortgagor's right to redeem (recover) the mortgaged asset on repayment of the secured debt) is only possible with a court order.

# 5. Do any limitation periods apply in relation to bringing an action to enforce security?

An action in simple debt is normally governed by the six-year limitation period for actions in contract and tort as stipulated by the Limitation Ordinance. The limitation period begins from the date on which the cause of action first accrues.

The Limitation Ordinance also provides that no action is permitted to be brought to recover any principal sum of money secured by a mortgage or other charge on property, or to recover proceeds of the sale of land, after the expiration of 12 years from the date when the right to receive the money accrued.

# 6. Is there any particular way in which secured assets must be liquidated on enforcement (e.g., by auction or court sale)?

There are no specific legal requirements on how secured assets must be liquidated on enforcement. Some relevant steps, however, in relation to the enforcement of security over real property, shares and movable assets are set out below.

Real property

A mortgagee must comply with its duties on the sale of the asset by acting in good faith and taking reasonable steps to obtain a proper price for the mortgaged property. Practically, this is usually done by way of an auction.

Foreclosure, which results in the lender becoming the absolute owner of the charged property, requires a court order.

Shares

Security over shares can generally be enforced without a court order. Depending on the terms of the security document, a lender usually has the right to sell the shares and exercise all the voting rights attached to the shares.

Movable assets

Movable assets secured by way of a fixed or floating charge are often realized by appointing a receiver to take physical possession of the assets and sell them. Usually the document creating the charge sets out the method of enforcement.

# 7. Are there any particular legal or practical difficulties or delays in enforcing security?

A debtor may resist the lender's attempt to enforce security, often by disputing the debt itself or by questioning the validity of the document creating the security. This often causes delays in enforcing the security.

# 8. In relation to enforcement, are there any specific requirements to be borne in mind if the lender is a foreign entity?

If a foreign entity that neither resides nor carries on business in Hong Kong brings proceedings to enforce security, the defendant may apply for security for costs of the action to be paid in court. The amount to be paid is generally an estimate of the defendant's costs in defending the action brought by the foreign entity. The court has discretion in relation to whether to grant this type of order, having regard to all the circumstances, including the plaintiff's prospects of success. However, security for costs is usually not required if the foreign entity has substantial property of a fixed and permanent nature within Hong Kong.

# 9. Is there any reason why you think that arbitration rather than litigation might be advantageous in resolving disputes under the finance documents, and if so, why? Please outline the relative merits of arbitration and litigation, including the ease of enforcement of foreign judgments and foreign awards from different jurisdictions. Is it possible to rely on a hybrid enforcement provision that allows the lenders to opt for either arbitration or litigation as they see fit?

Confidentiality

Arbitration proceedings are typically private and confidential. By contrast, court proceedings are open to the public and the judgments are public documents. Parties normally opt for arbitration if the dispute is commercially sensitive.

Procedural matters

The arbitral tribunal can conduct the arbitration in the manner that is most efficient and expeditious without being bound by local court procedural rules. A common example is that the rules of evidence are not generally applicable in arbitrations.

Court hearings are governed by a fixed set of procedural rules. This may offer certainty to the parties over the more flexible but uncertain procedures in arbitration and, in some cases, can reduce delay in the proceedings.

Summary procedure

Under Hong Kong court rules, there is a summary judgment procedure for obtaining judgment in cases where there is no dispute about the facts. While institutional arbitration rules commonly used in Hong Kong allow an arbitral tribunal to decide points of law or fact in an early determination procedure, a summary judgment is not available in arbitration. As disputes under finance documents usually do not involve complex factual issues, the lack of a summary judgment procedure could increase time and costs in an otherwise straightforward case.

Enforceability

An arbitral award rendered in Hong Kong can be enforced in over 170 party states to the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards, including most of the major business centers, as well as in Mainland China.

A foreign court judgment is enforceable by way of registration or under the common law if certain requirements are fulfilled. If the judgment is entered in Mainland China, the judgment may be enforced under the relevant Hong Kong Ordinance implementing the applicable Hong Kong/Mainland China arrangement on reciprocal recognition and enforcement of judgments. The existing arrangement under the Mainland Judgments (Reciprocal Enforcement) Ordinance (Cap. 597) ("**Old MJREO**”) will be replaced effective 29 January 2024 by the new Mainland Judgments in Civil and Commercial Matters (Reciprocal Enforcement) Ordinance (Cap. 645) (“**New MJREO**”). However, the Old MJREO will continue to apply in certain cases even after the New MJREO has taken effect.

Appeals

Unlike litigation, there is generally no right of appeal in arbitration, unless the parties expressly agree on a right of appeal. Even in those circumstances, the right of appeal is limited.

Costs

While arbitrations require parties to pay the costs of the arbitral institution and arbitral tribunal whereas there is no or minimal costs in using the public court facilities in litigation, the cost difference between arbitration and litigation (in terms of legal fees) is usually not significant.

**Hybrid enforcement**

It is possible to adopt dispute resolution provisions that allow lenders to opt for either arbitration or litigation as they see fit.

# 10. Are asymmetrical jurisdiction clauses enforceable? (By this we mean clauses that allow the lenders, but not the borrowers, to make certain choices in relation to choice of jurisdiction and how to litigate. These types of clauses allow the lenders, but not the borrowers, to commence proceedings in any court they choose, but restrict the borrowers to commencing proceedings in one jurisdiction only. This may also allow the lenders, but not the borrowers, to choose whether to litigate the finance documents before a court or to submit to arbitration in relation to them, but restrict the borrowers to either litigation or arbitration, as specified in the agreement).

Hong Kong courts generally give effect to the contractual agreement of the parties, save in exceptional circumstances.

There is one case where a Hong Kong court held that a clause that gave only one of the parties the right to refer a dispute to arbitration was within the meaning of an "arbitration agreement" of Article 8(1) of the UNCITRAL Model Law (*China Merchants Heavy Industry Co Ltd v. JGC Corp* [2001] 3 HKC 580). More recent authorities further support the proposition that Hong Kong courts accept asymmetrical clauses.

While an asymmetrical jurisdiction clause is likely to be enforceable in Hong Kong, there may be additional considerations when the party with the option to choose the jurisdiction (i.e., usually the lender) wants to enforce a judgment in Mainland China through the Old MJREO, where the underlying contract contains an asymmetrical jurisdiction clause. Under the Old MJREO, to enforce the Hong Kong judgment Mainland China, the Hong Kong court needs to have exclusive jurisdiction, as agreed by the parties to the underlying contract. In *Industrial and Commercial Bank of China (Asia) Limited v. Wisdom Top International Limited* [2020] HKCFI 322 (which was followed in *TransAsia Private Capital Ltd v. Cheng Yu* [2022] HKCFI 1295), the Hong Kong court held that an asymmetrical jurisdiction clause is not an exclusive jurisdiction clause and so a judgment based on such contract would not be enforceable in Mainland China under the Old MJREO.1

1 However, as indicated in the response to question 9 (under “Enforcement”), the New MJREO will take effect on 29 January 2024, in order to implement the new arrangement entered into by Hong Kong and Mainland China (the "Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters between the Courts of the Mainland and of the Hong Kong SAR" of 18 January 2019 ("**2019 Arrangement**")). Under the 2019 Arrangement, the requirement that the judgment needs to be from a court with exclusive jurisdiction is abolished.

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