GAR Global Arbitration Review

The Asia-Pacific Arbitration Review

2024

Asian private equity and international arbitration: key current issues

The Asia-Pacific Arbitration Review

2024

The *Asia-Pacific Arbitration Review 2024* contains insight and thought leadership from 58 pre-eminent practitioners from the region. It provides an invaluable retrospective on what has been happening in some of Asia-Pacific's more interesting seats.

This edition also contains think pieces on complex financial instruments, private equity and investor–state arbitration, and several on new frontiers in energy disputes.

All articles come complete with footnotes and relevant statistics.

Generated: February 8, 2024

Asian private equity and international arbitration: key current issues

Martin Rogers, **Jonathan K Chang** and **Clement Sung**
Davis Polk & Wardwell

Summary

IN SUMMARY

This article explores key issues arising from economic headwinds that have faced private company investors in Asia and their investee companies, giving rise to complicated legal issues due to potentially overlapping rights and obligations provided for in a company's constitutional documents (often without an arbitration agreement) and shareholders' agreements with investors (usually containing an arbitration agreement). We consider two issues in this context: information rights and raising funds from existing shareholders. We also share insights on recent decisions about the overlapping jurisdiction of the courts and submission to arbitration.

DISCUSSION POINTS

- Practical challenges to effective enforcement of information rights
- Contractual protections to fortify information rights
- Legal and commercial considerations when private companies raise new funds from existing shareholders
- Developments in how Hong Kong, British Virgin Islands and Cayman Islands courts deal with the overlap between winding-up petitions and disputes subject to arbitration agreements
- Enforceability of interim freezing awards in the Cayman Islands

REFERENCED IN THIS ARTICLE

- *Re Lam Kwok Hung Guy*
- *Re Southwest Pacific Bauxite (HK) Ltd*
- *But Ka Chon v Interactive Brokers LLC*
- *Al-Haidar v Rao et al*

OVERVIEW

Over the past year, private company investors in Asia have continued to face significant headwinds. Portfolio companies have been buffeted by the ongoing tensions between China and the West, as well as ongoing economic turbulence in the wake of covid-19 pandemic-related restrictions, increased costs of funding, lower asset values, Chinese policy and regulatory restrictions over certain Chinese industries and, in a few cases, outright fraud and diversion of business opportunities by key members of management or founders. Significantly more private companies, regardless of whether they were a start-up or at a more mature stage, failed to meet investors' expectations, necessitating those investors to consider how best to either provide meaningful assistance to investee companies or restructure (or exit) their investments. Private companies faced a difficult environment for raising new funding to extend their runways, leaving many seeking to raise higher-cost new capital from existing investors – those willing to add to their existing commitment, that is – to avoid the ultimate demise of the company. While the early part of 2023

suggests that better times may be ahead, arbitration practitioners are likely to be dealing with the fallout from these troubled times for the foreseeable future. These scenarios raise complicated legal issues due to potentially overlapping rights and obligations provided for in a company's constitutional documents (often without an arbitration agreement) and shareholders' agreements with investors (usually containing an arbitration agreement).

In this article, we consider practical issues facing both investors and investees in this environment. First, we look at information rights, which take on increasing importance in a downward-trending economy, and consider the practical value of such rights to investors, given the challenges of enforcing them in a timely manner in arbitration. Next, we consider areas of contention when private companies seek to raise funds from existing investors. Finally, we provide an update on how relevant jurisdictions have dealt with the overlapping jurisdiction of the courts and submission to arbitration – in particular, in the context of the intersection between insolvency and arbitration – and how recent Court of Appeal decisions in Hong Kong may lead to an (even more) pro-arbitration environment.

INFORMATION RIGHTS

Investors in private companies typically negotiate for, and obtain, rights to receive certain financial and operational information from the investee company. The precise information required to be provided, and the circumstances under which the company must provide the information, can vary. At one end of the spectrum are obligations imposed on the company to affirmatively provide information as frequently as on a monthly basis. At the other end are investors' rights to request inspection of a company's books and records, which are generally found in both the constitutional documents of a company and in a privately negotiated shareholders' agreement. Investors' utilisation of their information rights in practice also differs, with some diligently obtaining the information to monitor their investment and influence decisions of the board or shareholders and other, more passive investors not pressing their rights to information until the company is clearly not meeting expectations. At that stage, investors generally look to exercise their information rights to understand the cause for underperformance and how to either help the investee company to reverse course or to exit the investment altogether. What happens, though, if a company fails to comply?

As with the breach of any provision of an investor agreement, breach of information rights provisions can give rise to a claim for breach of contract, which in Asia is generally resolved through arbitration. Points of contention typically include the precise nature and scope of information that is required to be provided or whether the investor had waived its rights (despite common non-oral waiver language) to obtain such information by failing to enforce the information rights earlier in the life of the investment. Resolving these disputes in arbitration can give rise to practical problems that bear advance consideration.

Remedy

Absent specific contractual remedies, the relief available from a breach of information rights provisions is limited to obtaining the information that was agreed to be provided. It is difficult for investors to establish that a failure to provide information alone caused any loss to the investor, particularly in turbulent economic times when an investor's loss can be the result of many different factors. However, some investor-friendly agreements provide that a breach of information rights provisions (among others) gives rise to the investor's right to request redemption of its shares at a preset price. Absent such a provision, investors are left to seek

specific performance, which is not a remedy available as of right but is an equitable remedy, subject to the discretion of the tribunal.

Timing

The discretionary nature of the remedy aside, for investors seeking specific performance, the time required to commence arbitration and obtain an adjudication from a tribunal – even on an expedited basis or by using an emergency arbitrator – may be too long to provide any meaningful relief for the investor. This is of particular concern where the investor is attempting at speed to change the company's strategy to avert potential insolvency, but cannot do so without information from the company. For example, an investor may believe that a company with a large catalogue of intellectual property should pivot from directly serving consumers to focusing on licensing arrangements with intermediaries, but cannot effectively advocate for such a change to the company's board or other shareholders without detailed financial and other information. By the time an award ordering the provision of information is obtained, it may be too late. This is exacerbated by arbitration agreements that include step clauses requiring pre-arbitration dispute resolution to occur.

Cost

Absent a remedy such as redemption, the cost of arbitrating a dispute concerning information rights may outweigh the utility of the information obtained. Moreover, where the company is on the verge of insolvency, the cost of arbitration and diversion of management attention might itself result in the company's insolvency – a result that neither the investor nor the company would like to see.

Fiduciary Duty

To the extent the investee company has breached its obligations under the articles of association (or similar constitutional documents), depending on the investors' objectives, consideration should also be given to whether such a breach gives rise to a breach of fiduciary duty (by the board) or, in serious cases, is a basis for a just and equitable winding-up petition (or both).

Recommendations

The above considerations should be taken into account when contemplating information rights. When negotiating investment agreements, investors would be well served by obtaining contractual provisions that provide a specific remedy for the company's breach of information rights – for example, a redemption right that is guaranteed by a third party with greater financial resources than the investee company. Absent such a contractual remedy, investors may be left without effective means of enforcing information rights.

RAISING FUNDS FROM EXISTING SHAREHOLDERS

Private companies running short on cash in turbulent economic times can face limited options for raising additional capital to fund their businesses. Often, existing investors are the best (or only) option as they already have a financial interest and believe in the company's trajectory. However, raising funds from existing investors – even if those investors are prepared to put more money on the table – can give rise to a number of potential disputes.

Valuation

To attract funding in difficult times, companies may have to agree with lead investors to a low, investor-friendly valuation of the company. This may suit those participating in the new investment well, but also be a source of concern for investors who have valued their investments internally (and to their own investors) at a higher level or stand to be diluted as part of the fundraising. Absent some indication that the investor-friendly valuation is the result of a breach of fiduciary duty (eg, interested directors negotiating the new funding round, directors ignoring independent advice suggesting a higher valuation or directors failing to seek alternative funding solutions at a higher valuation), other investors are generally left with few legal protections and must instead focus on commercial options.

Dilution Of Existing Shareholders

The interests of the lead investors in the new financing often conflict with other existing investors. Those leading the new round of financing generally, for understandable reasons, seek to increase their interest in the company by diluting other existing investors through the new funding round. For example, we have observed companies including pay-to-play provisions in the terms of new financing that require existing shareholders to invest on a pro rata basis; failing to do so results in the conversion of preferred shares to ordinary shares. Such a structure pushes existing investors to invest in the new funding round or face significant dilution. Investors that may be diluted are presented with the choice of agreeing to participate in the financing to avoid dilution, or attempting to block or amend the terms of the new financing to maintain the status quo. With well-drafted agreements, the latter may not be legally possible.

Buyout

Faced with a call from the company to invest more money, some investors seek to cut their losses and try to force a buyout of their investment. The viability of a buyout often depends more on the commercial context of the situation than legal rights, particularly where a company is running short on cash and has already agreed to a less-than-ideal valuation with new investors. However, rather than throwing good money after bad, we have observed investors believing that negotiating a buyout is the best of the less-than-ideal options available.

Recommendations

The rights and obligations of investors and the company in these scenarios arise from a combination of existing shareholders' agreements, the constitutional documents of the company and the terms of the proposed new financing. Therefore, when considering legal remedies in these scenarios, it can be less than clear-cut whether such remedies are subject to arbitration agreements or not. Those involved need to think through their commercial objectives clearly and develop a legal strategy that best serves those objectives, involving potential arbitration or litigation, or both.

WHEN INSOLVENCY WINDING-UP PETITION MEETS ARBITRATION AGREEMENT

Liquidation is generally a last resort for all involved – neither the company nor any of its investors (certainly those with equity) wish to see it happen. However, there are circumstances where a winding-up petition is the most commercially viable option available, assuming investors cannot enforce directly against assets through security rights. For investors in private companies, the basis for winding up could be a serious breach of a shareholders' agreement, which typically includes an arbitration agreement. The manner in

which courts address winding-up petitions in such a scenario is ever-evolving and is explored below.

In the previous edition of this article, we analysed the pro-arbitration English approach to winding-up petitions on the grounds of insolvency, as established in ***Salford Estates (No. 2) Ltd v Altomart Ltd (No. 2)***.[1] It was held that the no summary judgment-type analysis would be conducted on an unadmitted debt that was subject to the arbitration agreement between the parties. The petition would be dismissed or stayed and the parties would be required to resolve the dispute over the debt through their chosen method of dispute resolution (ie, arbitration). This contrasts with the slightly more conservative approach adopted by the courts in the Cayman Islands and the British Virgin Islands, also discussed in our previous article, requiring the existence of a bona fide defence to the debt on substantial grounds for the dispute to be referred to arbitration.

In this article, we go one step further and dive deep into recent Hong Kong court decisions addressing the intersection of arbitration agreements and insolvency winding-up petitions. In particular, we examine the reasoning underpinning the Hong Kong Court of Appeal decision in ***Re Lam Kwok-Hung Guy*** (***Guy***),[2] which has brought Hong Kong's position in line with the English position.

Hong Kong Courts' Jurisdiction

A company incorporated in Hong Kong is a legal entity, meaning that its creation and liquidation are governed by statute. Section 177 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance[3] gives Hong Kong courts the jurisdiction to wind up a company (locally incorporated or offshore, but with sufficient nexus to the Hong Kong jurisdiction) on a number of grounds, one of which is that the company is unable to pay its debts (ie, insolvency grounds).

In practice, an unpaid and unsecured creditor with an unsatisfied statutory demand may file a petition to a Hong Kong court to wind up an insolvent company. However, at this stage, the creditor does not seek to recover the sum owed, but to put the insolvent company into liquidation for the benefit of all its creditors who are not parties of the petition. In other words, distinct from an ordinary action where the parties seek the court's determination as to their respective individual rights and liabilities, the order sought to wind up an insolvent company is a remedy affecting the company's creditors as a class.[4] It is a class remedy.

The court hearing the petition has the discretion to dismiss or stay the petition, or make any other order it sees fit. The question is how the court should exercise its discretion when the petition was taken out on the basis of an unsatisfied debt and the debt arose from an agreement that has an arbitration clause.

Noteworthy Case And Diverging Opinions

The landmark authority in this regard is ***Re Southwest Pacific Bauxite (HK) Ltd*** (***Lasmos***),[5] in which the petitioner, Lasmos Ltd, sought to wind up the company that it had invested in on insolvency grounds. The alleged debt arose from a management services agreement that contained an arbitration clause.

Prior to ***Lasmos***, the general position in Hong Kong could be summarised as follows:

- the court's first step was to decide whether a debt was owed and the test was whether there was a bona fide dispute over the debt on substantial grounds;[6]

- whether to make a winding-up order, or strike out or stay the petition, were matters left to the discretion of the court in light of all circumstances;[7] and
- while the existence of an arbitration agreement, or even the fact that the arbitration had been commenced, was one of the circumstances to be considered, it was not in itself determinative[8] – in other words, the court was still required to enquire whether there was a bona fide dispute on substantial grounds over the alleged debt even though the debt dispute was subject to an arbitration agreement.

After reviewing relevant authorities in Hong Kong, the United Kingdom and Singapore, the judge decided to depart from the earlier Hong Kong decisions and held that a winding-up petition should 'generally be dismissed' if:[9]

- the company disputes the debt;
- the contract under which the debt is alleged to arise contains an arbitration clause that covers any dispute relating to the debt; and
- the company has taken the steps required under the arbitration clause to commence arbitration, which may include preliminary actions such as mediation.

Applying this approach, the judge held that the petition of the case should be dismissed in the circumstances. In the judge's view, the court should be holding a creditor to their contractual agreement; namely, to resolve any dispute by arbitration.[10] The question of whether the petitioner, who is a creditor, is a member of the class is materially different to the question of whether the class remedy of a winding-up order should be granted. The former issue does not concern considerations relevant to the class generally and there is no reason in principle that the issue cannot be determined through arbitration.[11]

The result of the ***Lasmos*** approach was that a debtor company, relying on the parties' arbitration agreement, would generally be entitled to have the petition dismissed without the need to show that a bona fide dispute on substantial grounds existed over the debt.

The ***Lasmos*** approach was revisited by the Hong Kong Court of Appeal in ***But Ka Chon v Interactive Brokers LLC*** (***But Ka Chon***).[12] In this case, the first instance judge had followed the pre-***Lasmos*** approach and dismissed the debtor's application to set aside a statutory demand issued by the creditor to prove insolvency of the debtor because there was no bona fide dispute and, in any event, the third requirement under ***Lasmos*** (ie, taking steps to commence arbitration) was not satisfied.

The Court of Appeal affirmed the first instance court's ruling without needing to decide on the correctness of the ***Lasmos*** approach. Nonetheless, the Court of Appeal observed that, while it is at the court's discretion to dismiss or stay a petition where the alleged debt arises from a transaction containing an arbitration agreement, the ***Lasmos*** approach seems to suggest that such discretion should be exercised in only one way: the petition should 'generally be dismissed' other than in exceptional circumstances upon satisfying the three requirements.-[13] The Court of Appeal took the view that it is a statutory right of a creditor to petition for winding-up on the grounds of insolvency, but the ***Lasmos*** approach was a substantial curtailment of that right.[14] However, the Court of Appeal acknowledged that considerable weight should be given to the parties' arbitration agreement when the court exercises its discretion.[15]

In light of the Court of Appeal's conservative comments in ***But Ka Chon***, the ***Lasmos*** approach has not been followed in subsequent decisions.[16] In these cases, the debtors were still required to show that there was a genuine or bona fide dispute on substantial grounds over the debt, before courts would consider a referral of the dispute to arbitration.

RECENT DEVELOPMENTS

On 30 August 2022, the Hong Kong Court of Appeal handed down a decision in the ***Guy*** case, in which a creditor filed a bankruptcy petition concerning a debt under a loan agreement that contained an exclusive jurisdiction clause. It provided that New York courts were to have jurisdiction over all disputes arising from the agreement. The debtor opposed the petition, in part on the grounds that the petitioner should have first commenced proceedings in New York to establish the defendant's liability under the agreement. That was rejected by the first instance court, which held that the debtor was required to show a bona fide dispute on substantial grounds in respect of the debt. The debtor appealed, contending that it was improper for the court to embark upon an inquiry that was contrary to the parties' choice of forum, relying on the ***Lasmos*** approach by analogy.

The Court of Appeal allowed the appeal and dismissed the bankruptcy petition. The Honourable Mr Justice Godfrey Lam, who wrote the leading judgment, held the following:

- While presumably a class remedy in the form of a winding-up order is available only at court, it does not follow that the question of whether or not the debt is disputed in good faith on substantial grounds may not or should not be determined through the agreed dispute resolution mechanism.[17]
- It is a strong policy of the law to require parties to abide by their contracts. An action brought in breach of such contracts will ordinarily be stopped unless there are strong reasons to do otherwise.[18]
- Simply stating that an exclusive jurisdiction clause is a factor to be considered is likely to give rise to uncertainty and conflicting approaches, as evidenced in the recent cases on arbitration clauses. If the court simply determines whether the petition debt is bona fide disputed on substantial grounds, an exclusive jurisdiction clause would hardly be given any relevance, because it is the exercise the court would in any event engage in without the clause.[19]

He therefore took the view that the same approach adopted in an ordinary action or a writ action – that exclusive jurisdiction clauses should ordinarily be given effect unless there are strong reasons to the contrary – should be extended to winding-up proceedings. The Court of Appeal held that where the debt on which a winding-up or bankruptcy petition is based is disputed, and the parties are bound by an exclusive jurisdiction clause in favour of another forum precluding the determination of that dispute by the court, the petition should not be allowed to proceed in the absence of strong reasons, pending the determination of the dispute in the agreed forum.[20]

While ***Guy*** involves an exclusive forum clause, rather than an arbitration agreement, the Court of Appeal's analysis is expected to apply equally to arbitration agreements. ***Guy*** marks a meaningful checkpoint, tilting the Hong Kong position towards the robust English approach established in ***Salford Estates (No. 2) Ltd v Altomart Ltd (No. 2)***. Of note, on 8 November 2022, the petitioner in ***Guy*** was granted leave to appeal to the Court of Final Appeal. One

would certainly hope that the highest court in the jurisdiction will take this opportunity to definitively resolve the diverging opinions.

OFFSHORE UPDATES

In contrast, the approach endorsed by the courts in the British Virgin Islands remained largely the same over the past year. In ***Kenworth Industrial Limited v Xin Gang Power Investments Limited***[21] – a decision handed down in late 2022 – the key issue was whether proceedings seeking the appointment of liquidators on just and equitable grounds should be stayed pending the arbitration that had been commenced in the Hong Kong International Arbitration Centre. The British Virgin Islands Commercial Court considered authorities from various jurisdictions, including those from Hong Kong, and held that the general position is to dismiss or stay an application to appoint liquidators in the face of an arbitration agreement, but it is 'not always the case, for example, where a proposed defence is an obvious "put-up" job' (ie, there is no bona fide dispute).[22]

Another exception to the general rule is delay in raising the arbitration agreement. In ***Sian Participation Corp (in liquidation) v Halimeda International Limited***,[23] the Eastern Caribbean Court of Appeal confirmed that, to secure an automatic arbitration referral order from the court, a company faced with a winding-up application in a matter that was the subject of a valid and operative arbitration agreement must file and serve a request for referral to arbitration by no later than the date of submission of the first statement on the substance of the dispute. It affirmed the lower court's decision that the arbitration point had been raised too late because the appellant's first statement on the substance of the dispute was not only filed after the deadline but also did not raise the issue of arbitration.

In the Cayman Islands, an appeal was recently heard before the Privy Council against the decision made by the Court of Appeal in ***FamilyMart China Holding Co Ltd v Ting Chuan (Cayman Islands) Holding Corporation.***[24] The Grand Court of the Cayman Islands decided to strike out certain elements of a petition to wind up a company on just and equitable grounds, and to grant a stay of the remainder until the underlying disputes between the shareholders had been resolved by arbitration, but the Court of Appeal held that no part of the winding-up petition was susceptible to arbitration. Its reasoning was that 'the underlying issues are central and inextricably connected to determination of the statutory question whether the company should be wound up on just and equitable grounds' and that the parties had not agreed to not present a petition against the company. As a result, the questions of winding up, and whether there were just and equitable grounds, were to be decided by the court. The Privy Council was asked to reconsider the question of arbitrability of the petition. The hearing took place in November 2022, but no judgment had been handed down as at March 2023. It therefore remains to be seen whether any change will be made to the approach taken by the Cayman Islands courts.

Despite the more conservative approach discussed above, the Grand Court of the Cayman Islands in ***Al-Haidar v Rao et al*** (***Al-Haidar***)[25] recently confirmed that foreign interim awards may be enforced as judgments in the Cayman Islands. The judge in this case adopted a 'somewhat rough and ready approach'[26] and preferred the view that the scope of the Foreign Arbitral Awards Enforcement Act (1997 Revision) (FAAEA), which implements the New York Convention, was implicitly expanded to incorporate not just the final award enforcement provisions, but also the interim measure enforcement provisions.

The FAAEA and the Arbitration Act 2012 govern the enforcement of foreign and domestic arbitral awards, respectively. While the enforcement of an arbitral award is not news in the jurisdiction,[27] this is the first time that a Cayman Islands court has decided that a foreign interim award imposing an asset freeze can be enforced as a judgment. This is a welcome development for investors in Cayman Islands-incorporated companies or companies with assets in the jurisdiction. The judge's liberal approach in ***Al-Haidar*** expands the scope of the FAAEA to cover interim freezing orders – an extremely useful tool that investors would often resort to if their offshore investment were to turn sour, even pending the final outcome of proceedings. This development may provide a helpful strategic opportunity for parties to ongoing arbitration.

Nevertheless, the significance of the progress should be taken with a pinch of salt. The judge's decision in ***Al-Haidar*** was made at an ex parte hearing and may be subject to challenge or not followed. Usually, orders of this nature include a provision staying enforcement for a particular period (usually at least 28 days if served outside the jurisdiction). As at March 2023, it remains to be seen whether there will be an application to set aside this judgment or whether the British Virgin Islands courts will follow suit.

* *The authors would like to acknowledge the contributions of Mark Qin and Johnny Yip to the preparation of this article.*

Endnotes

1 [2015] Ch 589. Back to section

2 [2022] 4 HKLRD 793. Back to section

3 Chapter 32 of the Hong Kong Basic Law. Back to section

4 Section 20 of the Arbitration Ordinance (Chapter 609 of the Hong Kong Basic Law), which adopts article 8 of the United Nations Commission on International Trade Law Model Law on International Commercial Arbitration, provides that: Back to section

5 [2018] 2 HKLRD 449. Back to section

6 ***Lasmos***, paragraphs 6 and 9. Back to section

7 ***Lasmos***, paragraph 8. Back to section

8 ***Lasmos,*** paragraph 9. Back to section

9 ***Lasmos,*** paragraph 31. Back to section

10 ***Lasmos,*** paragraph 28. Back to section

11 ***Lasmos,*** paragraph 27. Back to section

12 [2019] 4 HKLRD 85. Back to section

13 ***But Ka Chon***, paragraph 62. Back to section

14 ***But Ka Chon,*** paragraph 63. Back to section

15 ***But Ka Chon***, paragraph 70. Back to section

16 See Re***Hongkong Bai Yuan International Business Co, Ltd*** [2022] HKCFI 960; ***DCKD v JPWL*** [2022] 4 HKC 261; and ***Pan Sutong v Bank of China Ltd*** [2022] HKCFI 1450. Back to section

17 ***Guy***, paragraph 81. Back to section

18 ***Guy***, paragraph 83. Back to section

19 ***Guy***, paragraph 85. Back to section

20 ***Guy***, paragraph 86. Back to section

21 Claims No. BVIHC (COM) 2022/0053 and No. BVIHC (COM) 2022/0065. Back to section

22 id. Back to section

23 BVIHCMAP2021/0017. Back to section

24 CICA (Civil) Appeals 7 and 8 of 2019. Back to section

25 FSD 328 of 2022, IKJ. Back to section

26 ***Al-Haidar***, paragraph 17. Back to section

27 See, for example, the decision by the Privy Council in ***Gol Linhas Aereas SA (formerly VRG Linhas Aereas SA) (Respondent) v MatlinPatterson Global Opportunities Partners (Cayman) II LP and others (Appellants) (Cayman Islands)*** [2022] UKPC 21. The decision of the Court of Appeal of the Cayman Islands that an International Chamber of Commerce arbitration award given under the New York Convention by an arbitral tribunal seated in Brazil was enforceable in the Cayman Islands was affirmed. Back to section

Martin Rogers martin.rogers@davispolk.com
Jonathan K Chang jonathan.chang@davispolk.com
Clement Sung clement.sung@davispolk.com

https://www.davispolk.com/