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Client Alert Commentary

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Hong Kong and BVI Courts Differ on Whether Noteholders Have Standing to Petition for Winding-Up

The Hong Kong Court confirmed that noteholders with beneficial interest in global notes do not have standing to present winding-up petitions against issuers. Meanwhile, the BVI Court reached the opposite conclusion in a separate case.

In the recent case of *Re Leading Holdings Group Limited* [2023] HKCFI 1770, the Hong Kong Court of First Instance (Court) decided, for the first time, on the issue of the *locus* of an investor of a global note to present a winding-up petition as a contingent creditor.

Having considered earlier authorities in various jurisdictions on the meaning of "contingent creditors" or "contingent liabilities", as well as the design and objectives of the global note structure, the Court held that the Petitioner, holding merely an indirect beneficial interest in the global note, and to whom the issuer (Company) owes no existing obligation, is not a contingent creditor and does not have standing to present a winding-up petition.

In its ruling, the Court followed the decision of the Grand Court of the Cayman Islands in *Re Shinsun*[1] handed down in April 2023. Notably, within a day of the Court's decision in *Re Leading Holdings* on 18 July 2023, the British Virgin Islands (BVI) High Court of Justice delivered judgment on the same issue in *Cithara v. Haimen Zhongnan*,[2] albeit against a slightly different set of facts and arriving at the opposite conclusion.

Background

In *Re Leading Holdings,* the Petitioner presented a winding-up petition against the Company on the grounds of insolvency and based on the amount owed to it under certain New York law-governed notes issued by the Company.

The notes were constituted by an indenture between the Company, the Trustee, and various guarantors. The Company's books show only one registered global note and only one registered holder of the global note (Holder), who also acts as the Trustee. The Petitioner, as an ultimate beneficial investor in the notes, was neither a party to the indenture nor a Holder under the terms of the indenture. Instead, the Petitioner had obtained a portion of the indirect beneficial interest in the global note via intermediaries, such as banks and brokers that held accounts with the clearing systems. Such clearing systems maintained a book-entry system through which transfers of beneficial interests in the global note are effected.

The Company sought to strike out the petition on the ground that the Petitioner did not have standing to present the petition. In particular, the Company contended that the Petitioner was:

1. a beneficial owner of a trust of a debt who, unlike an equitable assignee of a debt, may not petition for winding-up; and

2. neither a contingent creditor nor a prospective creditor of the Company, since no debtor-creditor relationship existed between the Petitioner and the Company, and the Company owed no existing obligation which may give rise to any contingent liability.

Decision

The Court ultimately found in favour of the Company on the standing issue. As a starting point, the Court held that the Petitioner has to discharge the burden of establishing its standing to present the petition as an essential element of its case.

Do Trust Beneficiaries Have Standing?

The Court agreed with the Company's argument that there is well-established authority to support the proposition that beneficiaries of a trust cannot sue on a debt and cannot present a winding-up petition (unlike equitable assignees who may sue on a debt and petition for a winding up — albeit subject to certain procedural requirements). Furthermore, Judge Suen SC refused to follow Harris J's decision in *Re China Cultural*,[3] since in that case, his Lordship appeared to have incorrectly conflated the position of a beneficiary of trust with an equitable assignee of debt, probably because his attention was not drawn to authorities on the position of a trust beneficiary.

Does the Petitioner Qualify as a Contingent Creditor for a Winding-Up Petition?

The Court concluded that the Petitioner did not have any existing contractual relationship with, nor directly enforceable rights against, the Company. On that basis, the Petitioner was not yet a creditor of the Company (whether contingent or otherwise) and did not have *locus* to present the Petition. In reaching this decision, the Court found as follows:

- **An existing obligation is required to qualify as a contingent creditor.** Having considered case law from various jurisdictions regarding the meaning of "contingent creditor" and "prospective creditors", including (amongst others) *Re William Hockley Ltd*[4] (a 1962 first instance English decision), *Community Development*[5] (a 1969 Australian High Court decision) as well as *Re Shinsun* (as mentioned above), the Court found that an existing obligation must already be in place in order for a person to qualify as a contingent or prospective creditor. Out of that obligation, there must be a liability on the part of the Company to pay a sum of money that will arise in a future event, whether it be an event that must happen (in which case, the liability will be a prospective liability) or only an event that may happen (in which case, the liability will be a contingent liability).

  The Petitioner contended that it should be considered a contingent creditor because under certain specified circumstances, it could request the issuance of definitive notes, whereupon it could directly enforce its claims against the Company. Accordingly, the Petitioner was a contingent creditor since the Company's liability was contingent on the issuance of definitive notes. However, the Court held that any obligation owed to the Petitioner under the notes arises only after the definitive notes have been issued to the Petitioner, and the Petitioner admitted that no such definitive notes have been issued to it. As such, until and unless the definitive notes are issued, the Petitioner is not yet a

creditor of the Company (whether contingent or otherwise). In this regard, the Court has adopted the same reasoning in the Cayman Court's decision of *Re Shinsun*.

- **The global note structure is premised on class action to be pursued by the trustee exclusively. Recognising a mere beneficial holder of the note as a contingent creditor may lead to duplicity of action and give rise to potential abuse.** In a typical structure of a global note, the trustee, as the exclusive channel of enforcement, represents and protects the bondholders who are treated as a class. By purchasing the bonds and consenting to a "no action clause",[6] bondholders have therefore waived their rights to bring claims that are common to all bondholders, and it follows that such claims can only be brought by the trustee. The very purpose of the regime was to ensure that the class of bondholders all acted through the trustee, such that "there was neither competition between the bondholders, nor the potential for multiplicity of actions or for duplication of actions brought by the trustee on the one hand and individual bondholders on the other".

  Therefore, if the Court considered a beneficial holder a "contingent creditor" without the holder first having acquired direct rights against the Company, this classification could lead to a potential of abuse. Applying the Petitioner's logic (i.e., a mere contingency that a legal relationship may exist between a person and the Company in future, will be sufficient to confer on that person standing to present a winding-up petition), every individual bondholder would be able to petition for the winding-up of the Company even before the notes matured, thereby leading to floodgates and defeating the purpose of the global note structure. The proper approach would therefore be that either the Holder or the Trustee shall petition as a contingent creditor (before the maturity of the notes) or as an actual creditor (after maturity); and, if individual account holders have acquired direct and enforceable rights against the Company (in this case upon the issuance of definitive notes), they may then petition as actual creditors.

- **The cases in which bondholders of a global note were recognised as "contingent creditors" for the purposes of voting on schemes of arrangement are not applicable to the context of winding-up petitions.** The Petitioner sought to rely by way of analogy on various authorities concerning schemes of arrangement in which a bondholder was allowed to vote as a contingent creditor. However, in rejecting that submission, the Court emphasised that the matter is context-specific, and that decisions made in the context of the meaning of "creditor" in the scheme legislation are distinct from that of "contingent creditor" in the winding-up legislation. In those cases, the voting rights on schemes which might affect economic interests were at stake, as distinct from *locus* to present a winding-up petition (which is a more draconian right than a mere voting right for schemes). Attaching undue weight to authorities concerning schemes is therefore inappropriate in the current setting.

Commentary

This decision signals the very clear stance the Court has adopted in rejecting winding-up petitions from individual bondholders for lack of standing as creditors (whether actual or contingent). The Court has therefore aligned its position with the Cayman Court on this important issue. Consequently, individual bondholders who wish to initiate winding-up proceedings or other legal actions in Hong Kong, whether as a pressure tactic or otherwise, may opt for a safer course in bringing action via the bond trustee. The obvious downside of this approach is that bond trustees may require the instructing bondholders to provide broad indemnities in favour of the trustees, as well as pre-funding upfront before they will take any steps towards enforcement. Such requests of indemnities and pre-funding could often delay, if not deter, bondholders' enforcements actions.

Diverging Court Decisions

As noted above, shortly after the *Re Leading Holdings* judgment was handed down, the BVI Commercial Court published its decision in *Cithara v Haimen Zhongnan,* in which the BVI Court reached the opposite conclusion and ruled that an ultimate beneficial noteholder under a New York law-governed note structure *is* a contingent creditor for the purposes of an application for the appointment of liquidators under the BVI insolvency legislation. More specifically, the BVI Court found that a contractual relationship is not necessary; the debtor must simply take steps to become liable to a creditor, subject to a contingency; and the bond structure can be equated and is analogous to the steps a debtor takes in order to become liable to a creditor, subject to a contingency. In reaching that conclusion, the BVI Commercial Court followed the UK Supreme Court decision in *Re Nortel*,[7] and declined to follow the Cayman Court decision in *Re Shinsun.*

In *Re Nortel,* the UK Supreme Court declined to apply a narrow meaning of "contingent liability" that is based upon "the legacy of the older principle that admitted only contractual debts to proof", and expressly overruled the English Court of Appeal's decision in *Steele*,[8] which in turn relied on both the decisions in *William Hockley* and *Community Development*.[9] As regards *Re Shinsun*, insofar as that decision relied upon *William Hockley* and *Community Development* and to the extent that it appears to have focused on whether a pre-existing direct contractual relationship existed, the BVI Court in *Cithara* took the view that the decision in *Re Shinsun* should not, and need not, be followed in the BVI.

Lastly, the BVI Court's decision in *Cithara* appears to place much weight on section 2.6 of the indenture, which incorporates section 5.3.1.3(a) of the Euroclear Operating Procedures, as well as an express authorisation by Euroclear in favour of the petitioner for it to maintain proceedings against the issuer. According to the BVI Court, the combined effect of those provisions and authorisation was that the petitioner, as the ultimate beneficial holder of a note structure, was entitled to enforce the Holder's claim against the issuer and can therefore be considered a contingent creditor of the issuer. Interestingly, a similarly worded section 2.6 can also be found in the indenture for the notes in *Re Leading Holdings*, but that specific wording and the Euroclear Operating Procedures were not specifically discussed. Further, it is unclear whether, in the case of *Re Leading Holdings,* the Petitioner obtained any express authorisation from Euroclear.

It is curious to see such divergence in authorities, especially within such a short period of time, and the question remains whether the Petitioner in *Re Leading Holdings* or the debtor company in *Cithara* will appeal the relevant decision in Hong Kong and in the BVI respectively.

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Endnotes

[1] *Re Shinsun Holdings (Group) Co., Ltd* (unreported, 21 April 2023).

[2] *Cithara Global Multi-Strategy SPC v Haimen Zhongnan Investment Development (International) Co. Ltd*. (Claim No. BVIHC(COM) 2022/0183).

[3] *Re China Cultural City Limited* [2020] 4 HKLRD 1.

[4] *Re William Hockley Ltd* [1962] 1 WLR 555.

[5] *Community Development Pty Ltd v Engwirda Construction* (1969) 120 CLR 455.

[6] I.e., a clause commonly observed in indentures which stipulates that the bondholders cannot directly enforce against the issuer under the indenture.

[7] *In re Nortel GmbH; Bloom v Pensions Regulator* [2013] UKSC 52, [2014] AC 209.

[8] *R(Steele) v Birmingham City Council* [2006] 1 WLR 2380.

[9] Interestingly, the decisions in *William Hockley* and *Community Development* were heavily relied on by the Court in *Re Leading Holdings.* Whilst *Re Nortel* was also referred to in the submissions of the Company's Counsel and in Judge Suen SC's judgment, it was interpreted very differently and relied on as supporting a narrower construction of the meaning of "contingent creditor".