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Client Alert Commentary

Latham & Watkins Restructuring & Special Situations Practice 14 June 2022 | Number 2968

Hong Kong Court Breathes New Life Into Rule in *Gibbs*

Judicial comments cast doubt on the ability to compromise US law-governed debt effectively based on Chapter 15 recognition alone.

A recent first instance decision in Hong Kong has relied upon the so-called rule in *Gibbs* to cast doubt on the ability of an offshore scheme of arrangement to compromise debt governed by a foreign law. In *Re Rare Earth*,[1] a case that on its facts did not seem to require consideration of the issue, Mr Justice Harris voluntarily joined the fray. In so doing, he highlighted an important conflict of laws issue that will inform debtor groups with a Hong Kong presence on where to promote a restructuring.

The rule in *Gibbs* is derived from a 19th century English case,[2] which decided that, as a matter of English law, only the governing law of a contract may validly discharge or amend it. Therefore, absent the agreement of the creditor (by its submission to the jurisdiction in question or by otherwise participating in the foreign proceedings), only an English law process may validly amend or discharge English law-governed debts.

Offshore borrowers and compromises of foreign law-governed debt

In *Rare Earth*, a Bermuda-incorporated borrower listed in Hong Kong and with operations in mainland China proposed a Hong Kong scheme of arrangement to compromise its largely Hong Kong law-governed debt. In sanctioning the scheme, the court was satisfied that the effect of the scheme would be recognised in Bermuda (the jurisdiction of incorporation) and the Cayman Islands (the jurisdiction of the scheme company's ultimate parent).

As the Hong Kong scheme compromised Hong Kong law-governed debt, the relevance to the case of the rule in *Gibbs* was not readily apparent. However, in obiter comments, the judge considered the effect of an offshore scheme of arrangement (for example, one proposed in Bermuda or the Cayman Islands) on Hong Kong law-governed debt. The judge found that, unless a creditor had submitted to the jurisdiction of the offshore scheme jurisdiction, the creditor would not be prevented from suing for its debt in Hong Kong because, under *Gibbs*, Hong Kong law-governed debt could only be compromised by a Hong Kong law process. That statement was helpful insofar as it removed any lingering doubt that the Hong Kong court would apply the rule in *Gibbs* in determining the effect of a foreign law compromise on Hong Kong law-governed debt.

However, the court extended its analysis still further to a hypothetical (but common) structure, under which an offshore-incorporated borrower with assets in Hong Kong has issued US dollar denominated debt under an instrument governed by New York law. How would the Hong Kong court treat the New York

law debt if the borrower successfully proposed a scheme of arrangement in the offshore jurisdiction and obtained recognition in the US under Chapter 15 of the Bankruptcy Code? The judge held that a Hong Kong court would not necessarily recognise the scheme as compromising the New York law debt. This was because Mr Justice Harris considered that any relief granted under Chapter 15 would not of itself compromise New York law debt as a matter of US law, but would be limited to ancillary relief to prevent a creditor taking action against the company (or its assets) in the US. In order to compromise the NY law debt substantively, Mr Justice Harris was of the view that a Chapter 11 plan would be required. His Honour commented that "*there is a distinction between a court treating a compromise as having the substantive legal effect of altering the legal rights of the parties to an agreement (the issue with which Gibbs is concerned) and a court within its jurisdiction recognizing, pursuant to a process such as Chapter 15, the purported legal consequence of a foreign insolvency procedure*". The result of this would be that a creditor with New York law-governed debt would be at liberty to seek recovery for its uncompromised claim in the Hong Kong court, and by extension petition to wind up the company in Hong Kong based on it notwithstanding any Chapter 15 recognition that had been obtained.

The extent of Chapter 15 relief and the intrusion of *Gibbs*

At first blush, this decision is surprising. Chapter 15 has been commonly used as a way of recognising compromises of New York law-governed debt by a foreign court (whether by way of scheme of arrangement or otherwise), and it has become common practice to obtain expert New York law advice confirming their effectiveness as part of a scheme of arrangement. Other affected jurisdictions tend to follow the lead of the US Bankruptcy Court insofar as matters of New York law-governed debt are concerned. The Hong Kong court's approach appears to raise uncertainty where, at least under the governing law of the debt (being New York law), no such uncertainty exists.

Mr Justice Harris cited in support of his view Judge Glenn's judgment in the Southern District of New York in the *Agrokor* case, granting Chapter 15 relief.[3] In *Agrokor*, a Croatian restructuring plan sought to compromise predominantly English law-governed debt. The US bankruptcy court granted Chapter 15 relief, notwithstanding that the rule in *Gibbs* might undermine the plan's effectiveness as a matter of English law. In short, the US court was prepared to overlook the territorialism of the *Gibbs* approach in favour of the direct application of Chapter 15 recognition and US case law, which is based on principles of international comity to respect the decisions of foreign courts and the UNCITRAL Model Law on Cross Border Insolvency. That would be the case even if the substantive result of the compromise is different from what might be available under US law.

Whereas the Hong Kong court in *Rare Earth* is correct to characterise Chapter 15 as a limited proceeding to "import" relief within the territorial boundaries of the US, it is unlikely that Chapter 15 imposes any limitation along the lines of the rule in *Gibbs* with respect to debt governed by US or any other law. On the facts in *Agrokor*, there would therefore likely have been be no limitation from the US perspective on the impact of a Croatian law restructuring plan on New York law-governed debt before the courts of New York, England, Hong Kong, or elsewhere. Moreover, there is no equivalent to the *Gibbs* rule in the US, and US courts have readily acknowledged the discharge of New York law-governed debts in non-US judicial proceedings. For example, in *Canada Southern Railway Co. v. Gebhard*[4] it was held that:

"Unless all parties in interest, wherever they reside, can be bound by the arrangement which it is sought to have legalized, the scheme may fail. All home creditors can be bound. What is needed is to bind those who are abroad. Under these circumstances, the true spirit of international comity requires that schemes of this character, legalized at home, should be recognized in other countries. The fact that the bonds made in Canada were payable in New York is unimportant…"

Whether or not the Hong Kong court's comments on the effect of Chapter 15 recognition are consistent with the US law analysis, the decision will likely prompt Hong Kong debtors incorporated offshore with New York law-governed debt to consider carefully whether to propose a creditor compromise under the laws of that offshore jurisdiction.

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Endnotes

1 Re Rare Earth Magnesium Technology Group Holdings Ltd [2022] HKCFI 1686; HCCW 81/2021.

2 *Antony Gibbs & Sons v. La Société Industrielle et Commerciale des Métaux* (1890) 25 QBD 399 (English Court of Appeal).

3 In re Agrokor d.d., Case No. 18-12104 (Bankr. S.D.N.Y. Oct. 24, 2018) (MG).

4 109 U.S. 527, 539 (1883).