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All's Well That Ends Well for Keepwell Providers?

No loss to issuers puts note trustees in the spotlight.

The Hong Kong Court of Final Appeal (CFA) has overturned the Court of Appeal's order that Peking University Founder Group Company Limited (PUFG), as the keepwell provider, breached the terms of the keepwell deeds and was liable to three of its offshore subsidiaries that were the issuers and a guarantor of the keepwell bonds (together, the Issuers), for the total outstanding amounts of those bonds (see our Client Alert).

Although the CFA accepted the Court of Appeal's finding that PUFG had breached its obligation to maintain liquidity of the Issuers (sufficient to meet their payment obligations under the bonds), it found that such breaches resulted in no actionable loss to the Issuers. This is because, had PUFG complied with its "liquidity obligation" by lending the requisite funds to the Issuers, the effect would have been to replace one liability of each Issuer (to their respective bondholders) with an equal liability (to PUFG). Applying the longstanding "net loss" rule,[1] the breaches by PUFG therefore resulted in no loss to the Issuers beyond nominal damages.

Whilst this outcome may be disappointing for some, the implications of the CFA's decision for holders as well as issuers of other keepwell bonds might not be as damaging as it first seems. Amongst other things, this decision provides much-needed clarity on the more appropriate plaintiff for bringing claims against a keepwell provider, namely the bond trustee on behalf of the bondholders.

This Client Alert summarises the CFA's decision and its implications for other keepwell bonds.

Court of Appeal's Decision

The Court of Appeal held that, properly construed, the keepwell deeds obliged PUFG to make payments to the Issuers so as to provide liquidity (totalling approximately US$1.7 billion) for them to meet their payment obligations under the bonds, and that PUFG was able to do so without the need for PRC regulatory approvals. As such, PUFG could not argue that, because it was impossible to obtain requisite PRC regulatory approvals *after commencement* of its bankruptcy case, it has already discharged its "best efforts" obligation by simply doing nothing, and it could not thereafter invoke the corresponding defence to absolve it from liability for any post-commencement breach. In rejecting PUFG's argument that its failure to provide liquidity by making a loan to the Issuers caused them no loss, the Court of Appeal adopted and re-expressed the reasons of Mr Justice Harris's previous findings at [92] of his judgment, and stated at [212]:

… PUFG argued that if it had transferred monies to an Issuer or Guarantor, it would have been treated as a loan with the consequence that the net balance sheet position would not have improved. The judge thought the argument is flawed. If the advance made by PUFG did not improve the net balance sheet position because of the way the advance was treated in the books of the Issuer or the Guarantor, the Consolidated Net Equity would have remained at a deficit. The Keepwell Deeds required PUFG to ensure that the Consolidated Net Worth [that is, the excess of the total assets of an Issuer and its consolidated subsidiaries over their total liabilities] and/or the Consolidated Total Equity of the Issuer or the Guarantor was US$1, and if that meant PUFG had to make a gift to the Issuer or the Guarantor to achieve that result, that was what was required. This also disposes of the argument that the Issuers and the Guarantors do not have standing to sue, because any breach of the Keepwell Deeds or EIPUs only caused loss to the bondholders.

The Court of Appeal declared that PUFG, having breached the keepwell deeds, was liable to each Issuer for the outstanding amounts under the respective bonds.

Court of Final Appeal's Reasoning

The CFA unanimously overturned the Court of Appeal's decision, on the basis of a narrow point that was the subject of the appeal: that a breach by PUFG of its obligation to provide liquidity to the Issuers caused no actionable loss. More specifically, the Court found that the loss claimed by the Issuers (and the subject of the declarations of the Court of Appeal) was only the pre-existing indebtedness to bondholders; if PUFG had, in compliance with the keepwell deeds, provided liquidity to the Issuers by making loans to them (which it was permitted to do), the Issuers would have had to use such proceeds to repay the bondholders, which would have involved replacing one liability (to the bondholders through the trustee) with an equal liability (to PUFG or another lender). It follows that non-compliance by PUFG made no difference and resulted in no net loss *to the Issuers*.

According to the CFA, how the Court of Appeal dealt with the question of loss by adopting Harris J's reasoning (as set out above) was problematic because, at this point ([92]) of his reasons, Harris J was dealing with the consequences of PUFG's breach of its obligation under clause 4.1(i), to maintain the consolidated net worth of FIHK (one of the beneficiaries under the keepwell deed), not clause 4.1(ii), to provide liquidity.

Counsel for the liquidators of the Issuers made four arguments in an attempt to establish actionable loss, but each was rejected by the CFA:

1. The Issuers made a bald and (in their view) "uncontroversial" assertion that, because they were entitled to be paid contractual sums under the keepwell deeds, PUFG's failure to pay the same (without more) amounted to provable debts in PUFG's insolvency. According to the CFA, that assertion was neither uncontroversial nor correct.

2. The Issuers contended that the keepwell deeds obliged PUFG to provide liquidity by way of a gift rather than a loan, because a loan would have put PUFG in breach of clause 4.1(i) of the keepwell deed (that is, its balance sheet obligation) in the same amount as the sum of any loan made. The CFA dismissed this argument. Amongst other things, if, as at 16 April 2020 (when the Court of Appeal found PUFG to be in breach of its liquidity obligation), the consolidated net worth of each of the Issuers was greater or less than US$1, it would not have been affected by a loan from PUFG to comply with its liquidity obligation. That is because the loan, once made, would have created a liability to repay PUFG (as the lender) and cash in an equal amount held by the Issuer (as the borrower), with the recognition of a pre-existing liability to the bondholders. And upon payment to the bondholders,

the cash asset would cease to exist, as would the liability to bondholders.

Further, the CFA refused to construe clause 4.1(i) of the keepwell deeds (in respect of which the Court of Appeal made no finding of breach) and clause 4.1(ii) (which the Court of Appeal found PUFG to have breached on 16 April 2020) in an inter-connected manner. In doing so, the CFA rejected the Issuers' proposition that, in providing funding under clause 4.1(ii), PUFG could not do so by loan, until any existing state of the consolidated net worth of the Issuers, if less than US$1, had been remedied. In any event, the Issuers did not plead or prove deficiency in their consolidated net worth as at 16 April 2020, when clause 4.1(ii) was to be complied with but breached.

3. The Issuers challenged PUFG's reliance on the general rule of "no net loss" and argued that damages should be awarded for the Issuers' loss of liquidity and their consequential liquidations caused by PUFG's failure to perform. The CFA rejected this claim because, although a breach could cause a lack of liquidity and subsequent liquidation to occasion loss, this had not been pleaded in the courts below and was not the subject of any evidential investigation. The loss pleaded and the subject of the Court of Appeal's declarations was simply the Issuers' pre-existing debt to the bondholders. As explained above, had PUFG advanced funds equal to the pre-existing debt (which is a permissible way of complying with clause 4.1(ii)), it would have had no effect on the Issuers' consolidated net worth.

4. The Issuers argued that, even if the "net loss" rule applied and the Issuers suffered no net loss, they could nevertheless rely upon the doctrine of "transferred loss" (being the losses of the bondholders) as a valid basis for claiming damages. The CFA also rejected this argument. The commercial reality was that the bondholders suffered loss, not the Issuers. There were only limited exceptions to the general rule that a claimant can only recover loss that it has itself suffered. The keepwell deeds did not present a "legal black hole" so as to justify engagement of the "transferred loss" doctrine, because the bondholders who suffered the ultimate loss were given the clearest of rights to sue for their loss through the bond trustee.

No Loss Equals Nominal Damages

Ultimately, the CFA concluded that awarding substantial damages to the Issuers, equivalent to the bondholders' debt, had no "commercial utility". The CFA found that the true loss caused by the keepwell provider was to the bondholders who were free to sue the keepwell provider via the trustee or prove in its re-organisation administration. Leaving the bondholders and their trustee to look after their own interests would cause no injustice. On that basis, the CFA varied the Court of Appeal's declarations such that they read as follows: "… that PUFG breached the Keepwell Deeds on 16 April 2020, but such breaches sound in nominal damages only."

Implications for Other Keepwell Bonds

Looking at the outcome of these proceedings in isolation, one could be forgiven for thinking that keepwell arrangements in general are an ineffective means of credit support and that keepwell deeds are not worth the paper they are written on. However, the CFA's decision shows that, had the case been pleaded differently at first instance, the outcome could have been very different. Further, the CFA is *not* saying that all keepwell obligations are unenforceable or that no loss can ever be suffered as a result of a breach of a keepwell deed. Rather, the CFA is simply clarifying the identity of the appropriate plaintiff for enforcing those obligations against the keepwell provider. In most cases, these are the bondholders via the trustee, instead of the issuer or the guarantor even though they are typically also named as parties to, and beneficiaries under, the keepwell deed[2].

Lastly, the CFA was concerned only with the question of loss (or lack thereof) caused *to the Issuers* by a breach of the liquidity obligation. It was not dealing with the question of loss that might have been caused by any breach of the balance sheet obligation. One should not overlook the fact that, at first instance, Harris J found in favour of FIHK to the effect that, at all material times from 31 December 2019, FIHK did not have a consolidated net worth of US$1; and, as at that date, FIHK had negative consolidated net equity of CNY1.15 million. Harris J then proceeded to declare that PUFG breached the keepwell deed and caused loss to FIHK in the sum of CNY1.15 million as at 31 December 2019, and his findings were not challenged on appeal. In the future, the liquidators of an issuer or a guarantor could still initiate legal actions on behalf of those entities against a keepwell provider, provided that they plead and prove on evidence a breach by the keepwell provider of its balance sheet obligation as well as a consolidated net equity of the issuer/guarantor that is of a substantial negative amount.

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Endnotes

[1] Most recently examined by the UK Supreme Court in *Stanford International Bank Ltd (in liquidation) v. HSBC Bank Plc* [2022] UKSC 34.

[2] Following the CFA's decision, the trustee filed a Hong Kong writ of summons against PUFG on 11 April 2025 demanding all amounts due under the bonds.