Winding-up Petition v Arbitration Clause: Hong Kong Court Dismisses Winding-up Petition in Favor of Arbitration Clause

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On 2 March 2018, the Hong Kong Court of First Instance (CFI) issued a notable decision which signifies a development of Hong Kong law in the contexts of insolvency and arbitration. The CFI held in *Lasmos Limited v Southwest Pacific Bauxite (HK) Limited* [2018] HKCFI 426 that a winding-up petition issued on the ground of insolvency should generally be dismissed if there is an arbitration clause contained in an agreement giving rise to a debt relied on to support the petition. This is a deviation from Hong Kong's previous position whereby such petition may only be dismissed by establishing a bona fide defence on substantial grounds to the claim for the underlying debt.

Facts

The winding-up petition was issued by Lasmos Ltd (**Lasmos**) against Southwest Pacific Bauxite (HK) Ltd (**Company**), for the latter's alleged failure to pay a US$259,700.48 service fee (**Debt**) under a management services agreement dated 24 July 2013 between the parties (**Agreement**). The Agreement contains a clause referring the parties' disputes to arbitration failing mediation.

The Company declined to pay the Debt on the basis that the parties had never agreed on the relevant fee and the rate to be charged. In resisting the winding-up petition, the Company submitted that this constitutes a "bona fide *dispute on substantial grounds*" as to what further sums were payable to Lasmos.

Legal principles

The CFI first summarised Hong Kong's previous position on the interplay between a winding-up petition and an arbitration clause:

- A winding-up petition based on the ground of insolvency will not be stayed to arbitration if the debt arises under an agreement which contains an arbitration clause; to defeat the petition, the debtor must demonstrate that it has a "bona fide *defence on substantial grounds to the claim for the underlying debt*" *(Re Sky Datamann (Hong Kong) Limited* (unrep., HCCW 487/2001)).
- In Re Quiksilver Glorious Sun JV Ltd [2014] 4 HKLRD 759, the Hong Kong CFI rejected the objection that because of its nature a just and equitable winding up cannot be stayed to arbitration. The correct approach is to identify the substance of the dispute between the parties and ask whether or not that dispute is covered by the arbitration agreement.

The CFI opined that these decisions had not discussed in detail whether a dispute between a petitioner and a company over a debt relied on to establish locus to present a winding-up petition is arbitrable, and observed that this was "*important in determining whether a creditor should be required to arbitrate a disputed debt before presenting a petition*" in recent English and Singapore decisions:

- The English Court of Appeal held in *Salford Estates (No 2) Ltd v Altomart Ltd (No 2)* [2015] Ch 589 (**Salford**) that a winding-up petition should be dismissed in favour of arbitration, noting that it would be "*anomalous, in the circumstances, for the Companies' Court to conduct a summary judgment type analysis of liability for an unadmitted debt, on which a winding up petition is grounded, when the creditor has agreed to refer any dispute relating to the debt to arbitration*", as that would be "*entirely contrary to the parties' agreement as to the proper forum for the resolution of such an issue and to the legislative policy of the 1996* [Arbitration] *Act*". The CFI drew similarities between the English Arbitration Act and the Hong Kong Arbitration Ordinance, noting that "[a]s *in England, the Legislature in Hong Kong has enacted legislation advancing a policy encouraging and supporting party autonomy in determining the means by which a dispute arising between them should be resolved*". *Salford* was subsequently followed in *Eco Measure Marketing Exchange Ltd v Quantum Climate Services Ltd* [2015] BCC 877, leading the CFI to conclude that "*the present position in England is that if an alleged debt arising under an agreement containing an arbitration clause is not admitted the petition should be dismissed*".
- With respect to the position in Singapore, the CFI found that *BDG v BDH* [2016] 5 SLR 977 (**BDG**) also adopted the *Salford approach*, which was consistent with decisions in Singapore granting a stay of proceedings in favour of arbitration. However, while the Singapore court held in *BDG* that it was not concerned with the strength of the company's defence, it wasnecessary for the company to demonstrate that there is a *prima facie* dispute, and that there is *prima facie* compliance with the dispute resolution clause.

The CFI's analysis

Comparing the different approaches taken by the Hong Kong authorities and the more recent ones in England and Singapore, the CFI concluded that the proper nature of a winding-up petition is for a creditor to recover its debt, rather than out of "*some altruistic concern for the creditors of the company generally*" as it would be "*the most efficacious method of obtaining payment*". The CFI noted that requiring a creditor to arbitrate a dispute without first determining whether the company has a *bona fide* defence on substantial grounds would, in fact, be holding a creditor to his contractual bargain – namely, to resolve any dispute by arbitration. The CFI found comfort in the fact that doing so would not deprive a creditor of an advantage that it has under the existing authorities, as there are circumstances in which a creditor whose debt is disputed would be justified in issuing a petition before an arbitration had been concluded. By way of an example, if a creditor can demonstrate a *prima facie* case for a winding up and a risk of misappropriation of assets or some other matter, a petition could be issued and stayed other than for applications relevant to the provisional liquidation pending determination of the arbitration.

Based on the foregoing, the CFI decided to depart from the previous approach in Hong Kong and held that a winding-up petition should generally be dismissed if: (a) a company disputes the debt relied on by the winding-up petitioner; (b) the contract under which the debt is alleged to arise contains an arbitration clause that covers any dispute relating to the debt; and (c) the company takes the steps required under the arbitration clause to commence the contractually mandated dispute resolution process and files an affirmation in accordance with Rule 32 of the Companies (Winding Up) Rules (Cap 32H) demonstrating this.

Applying the new test to the present case, since the Company disputed the Debt and required the dispute to be resolved in accordance with the arbitration clause in the Agreement, the CFI found that Lasmos' petition should be dismissed. In any event, the CFI found that it would have dismissed the petition since it was arguable on the facts that the parties' discussions fell short of arriving at a binding agreement on fees resulting in the claim for a liquidated debt, i.e. there was a *bona fide* dispute on substantial grounds.

Conclusion

This case is significant for both creditors and debtors, in that a winding-up petition may now be dismissed based on the existence of an arbitration clause in an agreement giving rise to the debt relied on for the petition. Previously, companies must positively establish that there is a "bona fide *dispute on substantial grounds*" in order to dismiss such petition. The present position represents a lower threshold in dismissing a winding-up petition. However, the Hong Kong courts have upheld the contractual bargain of the parties to arbitrate in dismissing a winding-up petition.

This case is a welcomed decision; it confirms the Hong Kong courts' pro-arbitration stance, as well as bringing Hong Kong in line with the contemporary jurisprudence in England and Singapore. In the eyes of the creditors, however, this case serves as a potential roadblock to winding up a company if there is a liquidated debt and the agreement giving rise to the debt contains an arbitration clause. Creditors must now take into account additional factors when pursuing a winding-up petition, such as the possible costs associated with an arbitration in settling a debt dispute.

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