Arbitration or winding up?

September 2019

Hong Kong – arbitration briefing

Introduction

In *But Ka Chon v Interactive Brokers LLC* [2019] HKCA 873, the Hong Kong Court of Appeal upheld a lower court's decision to reject an application to set aside a statutory demand. The appellant had argued (among other things) that an arbitration clause in his agreement with the respondent required their dispute to be referred to arbitration. In rejecting the appeal, the Court of Appeal sought to clarify the circumstances in which insolvency proceedings should be stayed or dismissed in favour of arbitration where that was the agreed form of dispute resolution. The decision casts doubt on a previous judgment which suggested that (save for exceptional circumstances) the insolvency proceedings should generally be dismissed where the debt is disputed, and the debtor has taken steps to arbitrate in accordance with the agreement.

Background

The appellant was a customer of the respondent. He suffered a large forex loss on his trading account and allegedly failed to comply with a margin call. The respondent liquidated the account and served a statutory demand requiring payment of the balance due.

The appellant argued that the demand should be set aside. He disputed the debt, alleging that misrepresentations were made to him prior to entering into the customer agreement, and also relied on an arbitration clause in the customer agreement, submitting that the dispute should be arbitrated.

At first instance, both arguments failed. The defence based on alleged misrepresentation was found to be without merit, and as such there was no bona fide dispute on substantial grounds requiring the demand to be set aside.

As for the arbitration agreement, the appellant sought to rely on *Re Southwest Pacific Bauxite (HK) Ltd* [2018] 2 HKLRD 449, a case decided by Harris J., which suggested that a petition to wind up a company should generally be dismissed where:

- the company disputes the debt relied on by the petitioner
- the agreement under the which the debt is alleged to have arisen contains an arbitration clause that governs any dispute relating to the debt, and
- the company takes steps to commence an arbitration and files evidence confirming this.

Any comments or queries?

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While the first instance judge in *But Ka Chon v Interactive Brokers LLC* did not seek to challenge *Re Southwest Pacific Bauxite (HK) Ltd*, he found that case did not apply because the appellant had not taken any steps to commence an arbitration, and he appeared to have no genuine intention of doing so.

In his appeal to the Court of Appeal, the appellant raised two grounds based on an alleged misunderstanding of the facts by the first instance court.

Of more interest, was the third ground of appeal. Namely, that the first instance court should have exercised its discretion, pursuant to rule 48(5)(d) of the Bankruptcy Rules (Cap. 6A), to set aside the statutory demand because the dispute should go to arbitration (following the approach adopted in *Southwest Pacific Bauxite (HK) Ltd*)[1]. The appellant also argued that the judge was in error in finding that he had not taken steps to commence an arbitration.

Decision

The Court of Appeal agreed with the first instance judge. The appellant's arguments on the merits of his defence were rejected, and the Court of Appeal also held that the first instance court was correct to find that the appellant had not commenced an arbitration proceeding and had no genuine intention of doing so.

Although this was enough to dispose of the appeal, the leading judgment in the Court of Appeal's unanimous decision casts doubt on the conclusions reached in *Southwest Pacific Bauxite (HK) Ltd*. These comments were obiter (they were not necessary for the decision, and are therefore non-binding) but practitioners would be unwise to ignore them.

The Court of Appeal's comments clearly favour the traditional pre-*Southwest Pacific Bauxite (HK) Ltd* position; namely, that a debtor contesting a winding up petition (or trying to set aside a statutory demand in a bankruptcy matter) must establish, with evidence, that there is a genuine defence to the debt based on substantial grounds. It is simply not enough to rely on an arbitration agreement, and merely allege that the debt is disputed.

The Court of Appeal pointed out that creditors have a statutory right to present a winding up or bankruptcy petition, and that the approach adopted in *Southwest Pacific Bauxite (HK) Ltd* was "a substantial curtailment" of that right[2]. The Court of Appeal appears to have considered that the earlier decision was a shift too far in debtors' favour, albeit that it recognised that earlier cases had not, perhaps, given adequate weight to the factor that the parties had agreed to arbitrate their disputes.

Comment and some takeaway points

Although the Court of Appeal's judgment calls into question the decision in *Southwest Pacific Bauxite (HK) Ltd*, it does not overrule it. Both the lower court and appeal judgments in *But Ka Chon v Interactive Brokers LLC* were able to decide that case without determining whether *Southwest Pacific Bauxite (HK) Ltd* was wrong.

For now, there are some important takeaway points.

- a party that seeks to dismiss a winding up petition, or to set aside a statutory demand in a bankruptcy matter, should try to demonstrate that the debt is disputed on substantial grounds, by filing evidence demonstrating that this is the case
- if the underlying debt arises out of or in connection with a contract containing an operative arbitration clause, the alleged debtor must be able to demonstrate that it has taken meaningful steps to commence an arbitration in accordance with the terms of the agreement. It is not enough simply to express an intention to arbitrate[3]

1. Rule 48 ("Hearing of application to set aside"). Rule 48(5) – "The court may grant the application if … – (d) the court is satisfied, on other grounds, that the demand ought to be set aside". Also see Rule 47 ("Application to set aside statutory demand").
2. *But Ka Chon v Interactive Brokers LLC* [2019] HKCA 873, at para. 63.
3. *But Ka Chon v Interactive Brokers LLC* [2019] HKCA 873, at para. 53: "It would make no sense to dismiss or stay an insolvency petition on the mere existence of an arbitration agreement when the debtor has no genuine intention to arbitrate". Quoted and applied in *Re Golden Oasis Health Ltd* [2019] HKCFI 2173, 6 September 2019 (at para. 40).

- for now, there is a tension between the decision in *Southwest Pacific Bauxite (HK) Ltd* and the obiter comments of the Court of Appeal in *But Ka Chon v Interactive Brokers LLC*. The Court of Appeal's comments are underpinned by strong policy arguments however, and they are also broadly consistent with the common law position in important offshore jurisdictions, such as (for example) the BVI[4]
- the view taken by the court about the correct approach to the exercise of its discretion, and the factors to be taken into account when doing so, is likely to be determinative in any particular case. As the Court of Appeal acknowledged[5]:
  "... considerable weight should be given to the factor of arbitration in the exercise of the discretion. It is right to heed the words of caution that 'exercise of the discretion otherwise than consistently with the policy underlying the [arbitration legislation] would inevitably encourage parties to an arbitration agreement – as a standard tactic – to bypass the arbitration agreement and the [arbitration legislation] by presenting a winding up petition' (*Salford*, at paragraph 40)[6].
  I also acknowledge it may well be that insufficient weight had been given to the arbitration factor pre-*Lasmos*" (ie pre-*Southwest Pacific Bauxite (HK) Ltd*)
- going forward, creditors and debtors should give more thought to whether an arbitration clause is suitable for their commercial agreements. Arbitration is not a panacea for all commercial disputes and insolvency and bankruptcy procedures have their place. This is particularly true of Hong Kong, which is generally regarded as a pro-creditor jurisdiction, irrespective of its high regard for arbitration. In the meantime, how much of *Southwest Pacific Bauxite (HK) Ltd* survives remains to be seen.

4. *But Ka Chon v Interactive Brokers LLC* [2019] HKCA 873, at para. 66 – referring to *Jinpeng Group Ltd v Peak Hotels and Resorts Ltd*, BVI HCMAP 2014/0025 and 2015/0003, 8 December 2015, Eastern Caribbean Court of Appeal.
5. *But Ka Chon v Interactive Brokers LLC* [2019] HKCA 873, at para. 70.
6. *Salford Estates (No 2) Ltd v Altomart Ltd (No 2)* [2015] Ch 589.

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