Will HK 'keepwell' decisions keep offshore bondholders 'well'?

Two recent court decisions in Hong Kong have given offshore bondholders new hope that the 'keepwell' deeds they were granted when lending hundreds of millions of dollars to Chinese companies will now be honoured and may have some value despite not being a guarantee.

Hong Kong's main commercial judge Mr Justice Harris made a key ruling in *Citicorp International Limited v Tsinghua Unigroup Co., Ltd* which acts as a useful and practical guide going forward.

That came shortly after an earlier decision involving the Peking Founder Group which held that the obligations contained in these deeds are enforceable in Hong Kong.

Keepwell deeds, which now cover many billions of dollars of Chinese bonds held by offshore investors, are usually governed by foreign law. Typically Hong Kong listed Chinese issuers of high yield bonds bought by offshore investors are governed under New York or English law.

However, the assets of these companies are generally on the Mainland and the proceeds to repay the offshore holders of these bonds requires approval from the Mainland authorities before cash can be remitted out of China.

What is a keepwell agreement?

In structure, a keepwell agreement is weaker than a guarantee but offers more protection than a letter of comfort. It is a contract typically whereby the onshore parent company agrees to ensure the bond issuing subsidiary can maintain solvency and has the ability to service payments due under the bond, either periodically or upon maturity.

The issuer of the bond often has no assets and no cash flow and therefore requires support from the wider group to be able to service the bond. The keepwell agreement provides investors with a form of credit enhancement designed to entice investors and boost confidence that the bond issuer will be able to meet its financial obligations in a timely way.

When the Chinese economy was booming, many companies used keepwell agreements when issuing high yield bonds, to encourage offshore investors to subscribe.

Now that the tide has turned, and the entire Chinese real estate sector, for instance, is experiencing financial hardship, these keepwell agreements are being tested for the first time in the Hong Kong Courts.

Such is the size and importance of the market that the Honourable Mr Justice Harris, Hong Kong's main commercial judge, decided to rule on two recent cases essentially together:

- In *Tsinghua Unigroup Co.*, Ltd the Hong Kong court awarded a trustee enforcing obligations under a keepwell deed more than US$489 million after finding the keepwell provider to be in breach.
- That ruling came shortly after an earlier decision involving the Peking Founder Group which ruled that the obligations contained in these deeds are enforceable in Hong Kong.

Hogan Lovells represented Citicorp in the Tsinghua proceedings.

Byron Phillips, Hogan Lovells

"It's a well-reasoned judgment that confirms the recent ruling in Peking Founder that keepwell obligations are enforceable in Hong Kong" said Byron Phillips, disputes partner at Hogan Lovells, who led on the dispute.

Jonathan Leitch, Hogan Lovells

Jonathan Leitch, Hogan Lovells' restructuring lead in Asia, added: "The Tsinghua ruling represents a significant victory for bond-holders and creditors enforcing agreements containing Hong Kong-exclusive jurisdiction agreements. However, the Peking Founder decision is now being appealed so the situation remains fairly dynamic."

Leitch said there were three key factors at play at the moment:

- Future enforcement of keepwell agreements could well turn on whether the keepwell provider can demonstrate the steps taken to obtain regulatory approvals to allow funds to be remitted offshore.
- The need for keepwell beneficiaries to demonstrate a keepwell provider has sufficient liquidity to comply with its keepwell obligations whilst also able to honour liabilities to its onshore creditors.
- Whether the terms of future keepwell agreements are modified to allow for regular monitoring of covenants and financial reporting to provide an early warning on the keepwell provider's solvency before it is too late.

This case has already involved offshore bondholders in a "dogged" two-year effort, said Phillips. Having completed its onshore debt restructuring Tsinghua Unigroup Co appears to have significant value. "It's still at an early stage," said Phillips. "The court has ruled, but any eventual pay-out could take some time yet."

Leitch sees further questions arising: Will this ruling create a trend?

Will offshore bondholders have to pursue their claims through the Mainland courts as well as Hong Kong's?

At the very least, it suggests that offshore investors need to push issuers for modifications in the terms of keepwell agreements.

Typically the bonds involved, US law-governed notes in high yield issues with a public subscription, require a threshold of 25 per cent of holders in order to start organising, with a view to instructing a bond trustee to take any enforcement steps.

Leitch reckons bondholders will be incentivised to organise earlier, "and be ready as soon as there is a trigger."