

## KEEPWELL DEEDS AND EQUITY INTEREST PURCHASE UNDERTAKINGS – SIGNIFICANT DEVELOPMENTS?

Keepwell deeds (KWDs) and equity interest purchase undertakings (EIPUs) have for some time been special features of offshore financings by Mainland<sup>1</sup> groups of companies. The recent decisions<sup>2</sup> of the Hong Kong Court of First Instance mark the first time a number of issues relating to KWDs and EIPUs have been considered judicially.

For the purpose of our summary of the PUFG cases and the Tsinghua case, two key points should be kept in mind:

- KWDs and EIPUs do not provide for any payment to be made to investors: rather, they provide for payment by (usually) the parent company of the relevant group to its issuer and/or guarantor subsidiaries, to put them in a position whereby they are able to discharge their payment obligations in respect of the relevant bonds or loans.
- generally, funds cannot be transferred from the Mainland (onshore) to an account outside the Mainland (offshore) without approval of Mainland authorities.

### PEKING UNIVERSITY FOUNDER GROUP - BACKGROUND

Peking University Founder Group Company Limited ("**PUFG**"), incorporated in the Mainland, is the holding company of a state-owned diversified conglomerate (the "**PU Group**"). Four offshore members of the PU Group (the "**Subsidiaries**"), incorporated in either the BVI or Hong Kong, issued or guaranteed US dollar bonds in 2017 and 2018 (the "**PUFG Bonds**"). The Bonds had maturity dates in 2020, 2021 and 2023, the earliest maturity date being in April 2020. PUFG entered into various KWDs and EIPUs with the Subsidiaries and the trustee for the PUFG Bonds. Those documents are all governed by English law but have Hong Kong exclusive jurisdiction clauses.

Under the KWDs, PUFG undertook to cause each Subsidiary to have a consolidated net worth of at least US\$1 at all times and sufficient liquidity to ensure timely payment of amounts payable under the PUFG Bonds, and in the case of one guarantor to have an aggregate total equity of at least HK\$9,980,000 at all times.

#### KEY TAKEAWAYS

- Keepwell deeds should not be categorised as guarantees, but they may not be worthless.
- The specific terms of a keepwell deed and the timing of events related to it and actions pursuant to it are of crucial importance.
- Identifying who has a remedy under a keepwell deed and how a remedy can be pursued requires careful analysis.

<sup>1</sup> The People's Republic of China other than the Hong Kong SAR, the Macao SAR and Taiwan.

<sup>2</sup> HCA 778/2021, HCA 798/2021, HCA 1418/2021 and HCA 1442/2021 [2023] HKCFI 1350; HCA 1269/2021 [2023] HKCFI 1572.

Under each EIPU, PUFG undertook following notice from the bond trustee to purchase the equity interests of certain offshore subsidiaries of PUFG for a price to be no less than the aggregate amount required to enable the Subsidiaries to discharge all their payment obligations under the PUFG Bonds. The commercial effect of such undertakings was to require PUFG to remit foreign currency funds (as the purchase price for the equity interests) out of the Mainland to the Subsidiaries, to pay outstanding amounts under the PUFG Bonds.

The KWDs and EIPUs **provided that** the performance by PUFG of its undertakings was subject to PUFG obtaining the necessary approvals from the relevant Mainland authorities (the "**Regulatory Approvals**"). PUFG undertook to use its best efforts to obtain the Regulatory Approvals within any applicable time stipulated by the relevant Mainland authorities.

The PU Group experienced financial difficulties and on 19 February 2020 the Beijing First Intermediate People's Court issued an order that PUFG commence reorganisation (the "**PUFG Reorganisation**") pursuant to the Enterprise Bankruptcy Law. Accordingly, the **PUFG Reorganisation** commenced before the maturity dates of any of the PUFG Bonds.

The Subsidiaries defaulted on their obligations under the PUFG Bonds. The bond trustee declared the occurrence of events of default under the PUFG Bonds and that all principal amounts and accrued interest were immediately due and payable. The bond trustee then sent notices to PUFG pursuant to the EIPUs requiring PUFG to purchase the equity interests of the relevant offshore subsidiaries of the PU Group.

PUFG did not make any payment under the KWDs or the EIPUs nor did it take any action to obtain the Regulatory Approvals.

Liquidators were appointed to the Subsidiaries, and the Subsidiaries submitted claims to the Administrator in the PUFG Reorganisation based on breach by PUFG of the KWDs and the EIPUs. All such claims (save one) were rejected.

The Subsidiaries commenced proceedings in the Hong Kong court against PUFG in respect of alleged breaches of the KWDs and EIPUs. At the hearing in the Hong Kong court the Subsidiaries did not pursue their claims in relation to the EIPUs, but the decision includes a number of findings concerning EIPUs.

## **PUFG - "BEST EFFORTS" TO OBTAIN REGULATORY APPROVALS**

The obligations of PUFG under the KWDs and the EIPUs (to make payments offshore) were not absolute (unconditional) obligations. If Regulatory Approvals were required, PUFG undertook to use its best efforts to obtain them. In this case, Regulatory Approvals were required. PUFG took no step to obtain the Regulatory Approvals. However, the Hong Kong court found that:

- the onus was on PUFG to prove on the balance of probabilities that despite using its best efforts it could not have obtained the Regulatory Approvals.
- there was a "material difference" between what PUFG had to show in respect of its obligations to use best efforts before and after the commencement of the PUFG Reorganisation.

- the expert evidence on Mainland law was that, once the PUFG Reorganisation had commenced, there was no realistic likelihood of the Regulatory Approvals being obtained.
- PUFG therefore had a defence to the claims brought by three of the four Subsidiaries that PUFG had failed to use its best efforts.

The situation was different with respect to the fourth Subsidiary, Founder Information (Hong Kong) Limited ("**FIHK**"). FIHK did not have a consolidated net equity of US\$1 as at 31 December 2019 (before the commencement of the PUFG Reorganisation). As PUFG had taken no action to obtain the Regulatory Approvals with respect to FIHK, it was in breach of its best efforts obligation under the relevant KWD, and accordingly FIHK had a valid claim against PUFG for breach of contract.

### **PUFG - QUANTUM OF LOSS**

The Hong Kong court found that the amount of FIHK's claim against PUFG for breach of contract was not the loss suffered by the PUFG Bond holders, but was the loss suffered by FIHK: that was the US\$ equivalent as at 31 December 2019 of RMB1,154,012,000.

### **TSINGHUA UNIGROUP - BACKGROUND**

Less than a month after its decision in the PUFG cases, the Hong Kong Court of First Instance released its decision in relation to bonds issued by an offshore subsidiary of Tsinghua Unigroup Co., Ltd. ("**Tsinghua**").

As the Hong Kong court commented in the Tsinghua decision, the legal issues in the PUFG cases and the Tsinghua case are the same and the facts "are remarkably similar". Tsinghua is incorporated in the Mainland, and is the holding company of a stated-owned diversified conglomerate. An offshore subsidiary issued US\$450,000,000 bonds (the "**Tsinghua Bonds**") in 2015 and 2016, guaranteed by another offshore subsidiary. The Tsinghua Bonds had a maturity date of 10 December 2020. Tsinghua entered into a KWD and an EIPU with the issuer, the guarantor and the trustee for the Tsinghua Bonds. The terms of the Tsinghua KWD and EIPU were substantially the same as the KWDs and EIPUs in the PUFG cases, including provisions that the obligation of Tsinghua to make payment was conditional on Regulatory Approvals being obtained, if required; Tsinghua undertook to use its best efforts to obtain the Regulatory Approvals.

In November 2020, Tsinghua was experiencing financial difficulties. On 10 December 2020 (the maturity date), the issuer and the guarantor failed to redeem the principal amount of the Tsinghua Bonds, and failed to pay interest on the Tsinghua Bonds.

On 16 July 2021, Tsinghua entered reorganisation (the "**Tsinghua Reorganisation**") pursuant to the Enterprise Bankruptcy Law – more than seven months after the maturity date of the Tsinghua Bonds.

Since the maturity date, neither the issuer nor the guarantor has made any payment in respect of the Tsinghua Bonds; Tsinghua has not made any payment under the KWD or the EIPU, and Tsinghua did not take any action to obtain the Regulatory Approvals.

The trustee for the Tsinghua Bonds submitted a proof of debt in the Tsinghua Reorganisation: the claim has not been determined (adjudicated) by the Administrator in the Tsinghua Reorganisation and has been given a "pending"

status. The trustee has not been notified that any payment in the Tsinghua Reorganisation will be made to it.

The trustee for the Tsinghua Bonds commenced proceedings against Tsinghua in the Hong Kong court, based on alleged breaches of the KWD and EIPU.

## **TSINGHUA – "BEST EFFORTS" TO OBTAIN REGULATORY APPROVALS**

A crucial difference between the PUFG cases and the Tsinghua case is that, in the Tsinghua case, the obligation of Tsinghua to use its best efforts to obtain Regulatory Approvals (to make a payment offshore) was engaged before the commencement of the Tsinghua Reorganisation. The Hong Kong court found that, once the Tsinghua Reorganisation had commenced, any attempt to obtain the Regulatory Approvals "would probably have been futile" (as the Hong Kong court had found in the PUFG cases). However, before the commencement of the Tsinghua Reorganisation, "the position was very different".

In addition, in December 2020 the guarantor of the Tsinghua Bonds was holding over US\$500,000,000 in offshore funds; and Tsinghua failed to establish in the Hong Kong court that there was any impediment to using these funds to make payment in respect of the Tsinghua Bonds or that it did not use the funds for that purpose because it believed Regulatory Approvals were required and they could not be obtained.

The Hong Kong court determined that Tsinghua had failed to demonstrate what steps it had taken to comply with its undertaking under the KWD and why those steps were unsuccessful. Accordingly, Tsinghua was in breach of its undertaking, and the Hong Kong court gave judgment in favour of the trustee for the Tsinghua Bonds in the sum of US\$483,843,533.

## **SOME GOOD NEWS**

The decision of the Hong Kong court in the PUFG cases was a declaration of the parties' entitlements: it did not order PUFG (or its Administrator) to make any payment, and the decision was favourable to only one of the four Subsidiaries. In the Tsinghua case, however, the claimant was the trustee for the Tsinghua Bonds, and the Hong Kong court ordered that Tsinghua pay the trustee over US\$483 million.

The positive aspects of the decisions are:

- the KWDs and EIPUs were presented (to potential purchasers of bonds) as having significant value and therefore the KWDs and EIPUs were intended to create substantive rights.
- the expert evidence on Mainland law was that the KWDs and the EIPUs did not violate any Mainland law or regulation, and there was no suggestion that the KWDs were unenforceable.
- PUFG was obliged to take steps under the KWDs to ensure that the Subsidiaries had sufficient liquidity to meet their obligations and PUFG's obligation was engaged when PUFG was aware that the Subsidiaries required additional liquidity. A requirement for the Subsidiaries to give notice to PUFG did not affect PUFG's obligations or the timing of their performance if PUFG was aware of the need for liquidity support.

- the submission by the trustee for the Tsinghua Bonds of a claim in the Tsinghua Reorganisation, which the Administrator has failed to adjudicate, did not operate to discharge the trustee's claim against Tsinghua.

## **WHAT DOES THIS MEAN FOR KEEPWELL DEEDS GOING FORWARD?**

Investors have generally recognised that KWDs and EIPUs are not guarantees and the terms of the offering circulars for the bonds made that clear. In the PUFG and Tsinghua cases, the specific terms of the KWDs and EIPUs, and the timing issues (in particular the commencement of the respective reorganisations), were of crucial importance. The Hong Kong court commented in relation to the PUFG cases that "in practice the [KWDs] and [EIPUs] were of limited practical value"; bond holders and bond trustees may have no direct claims under them, the amount of any claim may not represent bond holders' loss, and the remedy available in respect of a KWD or EIPU may not be for the payment of a debt.

The decision in the Tsinghua case, however, shows that in appropriate circumstances the Hong Kong court will make an order for the payment of a substantial amount in favour of a trustee for bondholders.

Overall, the decisions of the Hong Kong court make it clear that:

- a keepwell deed will generally be considered a legally binding document.
- the expert evidence on Mainland law, accepted by the Hong Kong court, was that the nature of keepwell deeds and equity interest purchase undertakings is not such as to violate Mainland law or regulation.
- the principal undertaking in a keepwell deed, if coupled with an undertaking to use best efforts to obtain regulatory approvals may, in appropriate circumstances, form a viable basis for a substantial claim against the issuer of the keepwell deed (typically, the holding company of the relevant group). However, the chance of success of such claim is likely to be substantially diminished if the principal undertaking in a keepwell deed is only triggered after the commencement of reorganisation of the issuer of the keepwell deed.

For investors contemplating an investment involving a KWD or EIPU, particular attention should be paid to its proposed terms and the level of comfort those terms represent in practice.

For investors who hold an investment supported by a KWD or EIPU, when an issuer or borrower group appears to be encountering financial difficulties the specific terms of the KWD and/or EIPU should be reviewed in the context of those financial difficulties, in order to determine whether it may be prudent to take prompt action, what that action might be, and who should take it.

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