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Recognition of Japanese Reorganization Proceedings

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In March 2004 the court in Hong Kong gave judgment in a case concerning the effect to be given to the reorganization of a Japanese corporation conducted under the Civil Rehabilitation Law 2000 of Japan ('the Rehabilitation Law'); and, in particular, whether a debt arising under a contract governed by Hong Kong law could be discharged or otherwise affected by the Japanese insolvency proceedings. The judgment in *Hong Kong Institute of Education v Aoki Corporation*[1] will be of interest to practitioners well beyond Hong Kong, since there is no material difference between Hong Kong and English law on this topic and the Hong Kong court's judgment contains an extensive review of the English case law and literature.

Legal background

There is a venerable rule of English law that a contract, and more particularly a debt arising under a contract, may only be discharged in accordance with its governing or 'proper' law.[2] Thus, as a general proposition, an English debt cannot be discharged by a foreign insolvency. (Although this rule is modified by statute in relation to United Kingdom insolvencies and will no longer apply in EC cases.[3]) Despite the fact that the discharge rule was initially laid down in the eighteenth century, in very different social and economic times, it has regularly been affirmed by the English courts – most recently by the House of Lords in *Société Eram Shipping Co Ltd v Cie Internationale de Navigation*[4] and the Privy Council in *Wight v Eckhardt Marine GmbH*.[5] Nevertheless, it was also noted long ago that the discharge rule is far from satisfactory and may operate in an unfair way.[6] For example, if the debtor were domiciled in New York, a New York bankruptcy would be recognized in England and would vest the debtor's English assets in the New York trustee. Yet, at the same time, the New York bankruptcy would not discharge any English debts. Hence, the debtor might, as far as English law was concerned, be left (perhaps for years) with liabilities but no assets from which to pay them.[7]

When turning to corporate insolvency, it is probably fair to say that the discharge rule – although affirmed by the Privy Council in a number of old cases[8] – was of limited importance, simply because the liquidation of a corporation would typically result in its demise as a legal entity. Discharge does not really matter if the insolvency terminates the existence of the debtor. However, the increasing global trend towards corporate rehabilitation has made the discharge rule that much more relevant today. It is not difficult to imagine a scenario where a corporation based in New York (or Tokyo or Beijing) goes into insolvent restructuring in its home jurisdiction[9] and subsequently, after the acceptance of its restructuring plan by the requisite majority of creditors, it emerges to continue its business activities (with or without

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1 12 March 2004, Reyes J. The judgment is available on Lexis and Westlaw, as well as the HKLII website <http://www.hklii.org> and the HK Judiciary website <http://www.judiciary.gov.hk/en/index/index.htm>.

2 See *Dicey and Morris: The Conflict of Laws* (13th ed., 2000) p. 1188–90; Fletcher, *Insolvency in Private International Law* (1999) pp. 104–10; and Smart, *Cross Border Insolvency* (2nd ed., 1998) Chapter 9.

3 See *Dicey and Morris*, p. 1190 and Supplement.

4 [2003] UKHL 30, [2004] 1 AC 260, at para 16 *per* Lord Bingham of Cornhill.

5 [2003] UKPC 37, [2003] 3 WLR 414.

6 Note *Shepherd v Beresford* (1851) 1 Mac & H 251.

7 See *Dicey & Morris*, p. 1189.

8 *New Zealand Loan and Mercantile Agency Co v Morrison* [1898] AC 349 and *State Aided Bank of Travancore Ltd v Dhrit Ram* (1941) LR 69 Ind App 1.

9 At common law, a foreign insolvency conducted in accordance with the law of the country of incorporation is entitled to recognition in England: see *Dicey & Morris*, p. 1181.

new management). The foreign restructuring law will naturally give the debtor a discharge from all relevant debts.[10] But the position is very different under English law. The foreign proceedings only discharge those debts governed by that foreign law. Thus the discharge rule may encourage an English creditor to wait until the corporation comes out of restructuring and then, perhaps some years later, seek to attach whatever assets may be found in England at that time (e.g. a debt owed by an English party to the corporation as a result of new trading activities). Such a course of action is not only at odds with any interpretation of a 'rescue culture', but it may also result in the uncooperative creditor recovering far more than the general body of creditors have received under the restructuring plan. In practice, in order to avoid such a scenario, the well-advised debtor may be compelled to go to the trouble and expense of putting in place an English version of the restructuring plan (perhaps by way of a scheme of arrangement) so as to ensure that English debts are discharged. Needless to say, this is far from satisfactory.

The disconnect in English private international law between, on the one hand, the recognition of a foreign insolvency and, on the other, the effect of a foreign discharge, has prompted a number of commentators to call for fundamental reform.[11] Yet, leaving to one side such fundamental reform, this commentator has argued that even under the present law there are two significant glosses to be taken into consideration.[12] First, that a creditor who actively participates in the foreign restructuring (for example, by entering a claim) should always be bound by the foreign discharge regardless of the proper law. There is long-forgotten case law[13] supporting this argument, but commonsense is doubtless the most pertinent argument. Secondly, even if an English debt is not discharged by the foreign insolvency proceeding, the recognition of the foreign insolvency may operate to prevent an English creditor from attaching the debtor's assets in England. This is because, it is suggested, there is a crucial difference between (a) the existence of a debt and (b) whether or not a creditor can attach assets. In short, if a debt is discharged it must necessarily cease to exist; if a debt is not discharged, because for instance English law ignores the foreign discharge, it simply means that there is a debtor-creditor relationship between the parties; and there is clear authority in the House of Lords' decision in *Galbraith v Grimshaw*[14] that, where a foreign insolvency is recognized in England, creditors will not be allowed to take advantage of a subsequent attachment of any assets that have vested in the foreign trustee (or, in the corporate context, any assets that fall to be dealt with in the foreign liquidation or restructuring).[15]

The decision of the Hong Kong court in *HKIE v Aoki* examines the relationship between the narrow discharge rule and this wider principle of recognition.

Hong Kong Institute of Education v Aoki Corporation

The facts of *HKIE v Aoki* arose out of construction contract disputes between the parties. HKIE had in the 1990s engaged Aoki as the main contractor under a number of building contracts relating to the construction of a campus in Hong Kong. Aoki was a Japanese corporation and operated in Hong Kong through a branch, rather than a subsidiary. The completion of the construction works was considerably delayed, with each side blaming the other. Meanwhile, in December 2001, Aoki sought protection from the Japanese courts pursuant to the Rehabilitation Law. Aoki was massively insolvent. Potential claims arising out of its Hong Kong activities were a fraction of its overall indebtedness. In due course, in March 2002, Aoki put forward a rehabilitation plan for consideration by its creditors. The plan envisaged the continued existence of Aoki with support of new investors. The creditors voted heavily in favour of the plan (even though many of the larger creditors were to receive only 2% on their claims and no equity); and, in June 2002, the plan was approved the Tokyo District Court.[16] Payments were made (and completed) on creditors' claims in September 2003.[17] All relevant restructuring proceedings took place in Japan; no scheme of arrangement was initiated in Hong Kong.[18]

Meanwhile, the dispute between HKIE and Aoki was continuing, each side asserting that it was owed damages by the other. In April 2002, arbitration

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10 Just as, of course, English law does so in corresponding circumstances, see *New Zealand Loan and Mercantile Agency Co v Morrison*, n. 8 above.

11 See, in particular, *Fletcher* at pp. 108–09.

12 See *Smart*, pp. 261–65 and 259–60.

13 *Ibid.*

14 [1908] AC 508.

15 See *Smart*, pp. 222–23.

16 These facts are all taken from the judgment of Reyes J.

17 Judgment, para 116.

18 Of course, if there had been a parallel scheme of arrangement in Hong Kong, HKIE's debt would have been discharged.

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proceedings were commenced in Hong Kong (HKIE claiming against Aoki and Aoki then counterclaiming). Those proceedings resulted, in December 2003, in an award for more than HKD50 million in favour of HKIE. At no stage did HKIE enter a claim in the Japanese rehabilitation. Nor, it appears, was any action taken in Japan to stay or otherwise seek to regulate the Hong Kong arbitration proceedings.

Armed with the arbitrator's award, HKIE applied to the court in Hong Kong seeking liberty to enforce the award in the same manner as a judgment of the courts in Hong Kong. Aoki resisted on the basis, *inter alia*, that Japanese law provided that all claims against the rehabilitation creditor existing at the time of the commencement of the rehabilitation were discharged by adoption of the rehabilitation plan. HKIE countered that its debt arose out of a contract governed by Hong Kong law (a fact which was not disputed) and that the Japanese law could not discharge a Hong Kong debt.

Reyes J referred to the case law supporting the proper law approach to the question of discharge[19] and noted Rule 170 of *Dicey and Morris*:

> A discharge from any debt or liability under the bankruptcy law of a foreign country outside the United Kingdom is a discharge therefrom in England if, and only if, it is a discharge under the law applicable to the contract.

His Lordship, however, also acknowledged the criticism of the traditional approach given by the editors of *Dicey and Morris*.[20] Reyes J also quoted extensively from Professor Fletcher in *Insolvency in Private International Law*, including the following passage:[21]

> The *Gibbs* doctrine [i.e. referring only to the proper law] belongs to an age of anglocentric reasoning which should be consigned to history. In its place, supplementary rules are required which take account of the circumstances under which the foreign proceedings were opened, and subsequently conducted, before reaching a conclusion about the international effects to be accorded to those proceedings and to any discharge or composition to which they give rise. Before any creditor can subsequently be permitted to take action in England to enforce an obligation which the defendant claims was comprised within the foreign discharge, but whose applicable law was not that of the country of bankruptcy, the court should have regard to whether the plaintiff had adequate notice of the foreign proceedings and a reasonable opportunity to participate in them in accordance with acceptable standards of fair and equal treatment. If this was the case, the remedies of English process should be withheld on the basis that the plaintiff is estopped from invoking them ... In seeking in this way to establish a more internationally enlightened mode of responding to the effects generated by foreign insolvency proceedings, English law would in fact be returning to the open-minded tradition of the formative period of this particular branch of our jurisprudence ....

In light of such criticism, Reyes J broadly adopted the approach suggested by this commentator, namely that the effect to be given to a discharge in foreign insolvency proceedings involves not one but two issues. A foreign insolvency will not discharge an English/Hong Kong debt, but the fact that the creditor has a valid debt (not extinguished by the foreign law) does not mean that the creditor is free to attach the debtor's assets as he pleases:[22]

> Smart thus suggests that the effect of a foreign discharge of a plaintiff's claim can be analysed in 2 stages. Insofar as a plaintiff seeks judgment, his claim is not struck out because the foreign discharge does not form part of the proper law which governs the contract and gives rise to the claim. Judgment may accordingly be entered in the plaintiff's favour. But, when it comes to the question of enforcing the judgment, insofar as the foreign proceedings giving rise to the discharge have consequences on a debtor's assets situate in Hong Kong (for example, the vesting of the debtor's movables here in a foreign trustee-in-bankruptcy), execution against such assets may be refused by the Hong Kong court.

(It must be stressed that the suggestion that a distinction has to be drawn between whether a debt has been discharged and whether the creditor can levy execution is not a new one: the issue was raised, although not decided, before the English Court of Appeal in *Gibbs & Sons v La Société Industrielle et Commerciale des Métaux*.[23]) Moreover, there are, as Reyes J noted in his judgment, many examples where

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19 In particular, *Gibbs & Sons v La Société Industrielle et Commerciale des Métaux* (1890) 25 QBD 399.

20 At pp. 1189–90. The criticism is, as mentioned above, that it will be recognized by the English court that the debtor's assets fall within the foreign insolvency proceedings but English debts will not be discharged.

21 *Fletcher*, at pp. 108-09.

22 Judgment, para 123.

23 Note 19 above.

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the court has recognized and given assistance to foreign insolvency proceedings[24] and, in particular, the court may prevent a creditor from subsequently attaching the debtor's assets in England.[25] Many of those examples have expressly applied the well-known statement of Lord Dunedin in *Galbraith v Grimshaw* that:[26]

> Now so far as the general principle is concerned it is quite consistent with the comity of nations that it should be a rule of international law that if the Court finds that there is already pending a process of universal distribution of a bankrupt's effects it should not allow steps to be taken in its territory which would interfere with that process of universal distribution ....

Accordingly, Reyes J held that although judgment would be entered for HKIE against Aoki (since Japanese law could not discharge a Hong Kong debt), HKIE would not be permitted to proceed immediately to execution.

There will be a further hearing later in the year before Reyes J in which the parties will make their submissions, *inter alia*, as to whether or not the Japanese Rehabilitation Law extends to assets in Hong Kong (i.e. is extraterritorial) and whether HKIE was given adequate notice of those proceedings and had a reasonable opportunity to participate therein.

Comment

HKIE v Aoki is to be welcomed, as it is the first modern case[27] to set out plainly the distinction between the discharge of a debt and the attachment of the debtor's assets and how the two issues are to be dealt with in a cross border insolvency case. Reyes J referred to a two-stage approach, although it is perhaps better to recognize that the two issues are conceptually quite distinct (although they may both arise in a single fact situation).

The practical effect of the judgment – assuming it is applied in subsequent cases in other common law jurisdictions – will be to shift the balance of power in favour of the foreign restructuring and against the individual or 'hold out' creditor. Let us say that an insolvent foreign corporation is proposing a restructuring plan in its home State and that the plan has clear support from most creditors. The plan envisages the introduction of new capital and the creditors taking a 75% haircut, with the remaining 25% being paid over the course of 4 years. However, there are a (small) number of English creditors, some of whom are against the plan. Whilst the foreign plan cannot discharge the English debts – except in relation to those English creditors who participate – *HKIE v Aoki* means that the English creditors will not be allowed to grab any assets in England during the 4-year period of the plan. Such a restriction makes it far more likely that the reluctant English creditors will opt, at the very outset, to throw their lot in with the general body of creditors, rather than deliberately stay outside the plan in the hope of being able to rely on the discharge rule and effect individual attachments on any assets that can be found.

However, this commentator has one difficulty with the judgment of Reyes J. The rule against a subsequent attachment of a foreign debtor's assets in England depends upon there being what was described in *Galbraith v Grimshaw* as a *pending* process of universal distribution.[28] Thus, in the example given above, an English creditor would not during the 4-year period be permitted to attach assets – because there is a pending process of universal distribution and an individual creditor should not be allowed to take steps which impact negatively upon that process. But in *HKIE v Aoki* the judgment itself[29] tells us that the Japanese proceedings had already been completed and all payments made to creditors by the time the arbitration award was made in favour of HKIE. It is to be hoped that, when the case comes back before Reyes J, this issue might be further elaborated.[30]

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24 Reyes J refers to *Banque Indosuez SA v Ferromet Resources Inc* [1993] BCLC 112 and *Barclays Bank plc v Homan* [1993] BCLC 680, as well as the Hong Kong cases of *Modern Terminals (Berth 5) Ltd v States Steamship Co* [1979] HKLR 515 (US Chapter 11) and *CCIC Finance Ltd v Guangdong International Trust & Investment Corp*, unreported, 31 July 2001 (Mainland PRC insolvency).

25 See the discussion of *Levasseur v Mason & Barry Ltd* [1891] 2 QB 73 in *Smart*, pp. 234–35.

26 [1908] AC 508 at 513.

27 For an old illustration from the Cape Colony, see *Cape of Good Hope Bank v Mellé* (1893) 10 J 280 discussed in *Smart*, p. 260 and referred to by Reyes J (judgment, para 122).

28 Text to n. 26 above.

29 Para 116: 'Aoki's civil rehabilitation was completed on 18 September 2002'. All payments had been made to creditors by September 2003 (*ibid*).

30 In addition, the current judgment does not clearly identify the assets in respect of which HKIE was seeking to levy execution.

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