

## Client Alert

### Debt Capital Market

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# Navigating the Legal Landscape of Keepwell Deeds and Equity Interest Purchase Undertakings: Insights from Recent High Court Decisions

#### Overview

On 18 May 2023 and 15 June 2023, the High Court of the Hong Kong Special Administrative Region (**Court**) handed down two landmark decisions relating to the enforceability of keepwell deeds and equity interest purchase undertakings (**EIPUs**) - *Nuoxi Capital Limited & Others v Peking University Founder Group Company Limited* [2023] HKCFI 1350 (**PekingU Case**) and *Citicorp International Limited v Tsinghua Unigroup Co., Ltd* [2023] HKCFI 1572 (**Tsinghua Case**) respectively.

Both cases revolved around the central issue of whether keepwell deeds and EIPUs are binding upon and enforceable against PRC<sup>1</sup> keepwell providers and the type of relief awarded to the parties upon breach of keepwell deeds or EIPUs by the keepwell providers.

Keepwell deeds and EIPUs are common forms of credit enhancement used by PRC companies in international bond offerings by their offshore subsidiaries. Under these documents, the keepwell provider (typically being the parent company in the PRC) usually undertakes, among other things, to ensure their offshore subsidiaries remain solvent and have sufficient liquidity to meet payment obligations under the bonds.

The adoption of such credit enhancement features gains popularity as keepwell deeds and EIPUs are not guarantees and hence do not necessitate compliance with the relevant registration requirements for cross-border guarantees under PRC laws and regulations. However, as these documents do not constitute outright guarantees, bondholders can only claim damages for breach of contract if the keepwell providers fail to perform their obligations under keepwell deeds or EIPUs. Once triggered, performance of keepwell obligations (which typically involve cross-border payments by a PRC company to its offshore subsidiaries) may well be subject to PRC regulatory approvals. Keepwell deeds and EIPUs therefore typically contain qualifying provisions whereby a keepwell provider may establish a defence for non-performance of its keepwell obligations in the event the keepwell provider is not able to obtain the requisite regulatory approvals despite having used its best efforts to do so (referred to below as the **regulatory approval defence**).

In both the PekingU Case and the Tsinghua Case, the Court expressly confirmed that keepwell deeds and EIPUs constitute binding and enforceable obligations of keepwell providers. In the Tsinghua Case, the Court awarded significant contractual damages to the trustee of the bonds. These landmark decisions are important and helpful for market participants as they confirmed the enforceability of keepwell deeds and EIPUs.

#### The PekingU Case

The PekingU Case involved four “intra-group” actions between Peking University Founder Group Company Limited (**PekingU**), a company incorporated in the PRC, being the keepwell provider of USD bonds issued by two of its offshore subsidiaries between 2017 and 2018, as the defendant, and four of PekingU’s offshore subsidiaries which include the two issuers and their respective guarantors of such bonds, as the plaintiffs.

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<sup>1</sup> References to **PRC** herein are to the People’s Republic of China (which for the purposes of this article only, shall exclude the Hong Kong and Macau Special Administrative Regions of the People’s Republic of China and Taiwan).

Subsequent to the bond issuances, the financial position of PekingU deteriorated. In February 2020, the Beijing First Intermediate People's Court (**Beijing Court**) ordered PekingU to commence reorganisation proceedings pursuant to the Enterprise Bankruptcy Law of the People's Republic of China.

Each of the plaintiffs (being the offshore issuers and guarantors of the bonds) failed to honour their respective payment obligations under the bonds as a result of the deteriorating financial state of the PekingU group and went into liquidation. Their liquidators commenced claims against PekingU for its failure to perform its keepwell obligations under the relevant keepwell deeds and EIPUs.

The Court found that in all but one<sup>2</sup> of the four actions, PekingU's failure to perform its obligations under the keepwell deeds and EIPUs occurred **after** the commencement of its reorganisation proceedings in the PRC. The Court agreed that once PekingU's reorganisation proceedings commenced, there was no realistic prospect of obtaining the necessary regulatory approvals required to perform PekingU's obligations under the keepwell deeds and EIPUs, and therefore held that even though PekingU took no steps to obtain any approvals, it was not liable for breach of the relevant keepwell deeds or EIPUs<sup>3</sup>.

### The Tsinghua Case

The Tsinghua Case involved a dispute between Tsinghua Unigroup Co., Ltd (**Tsinghua**), a company incorporated in the PRC, being the keepwell provider of USD bonds issued by its offshore subsidiary between 2015 and 2016, and Citicorp International Limited (**Citicorp**), being the trustee of such bonds.

Similar to the PekingU Case, the financial position of Tsinghua deteriorated after the bonds were issued. The issuer and guarantor of the bonds defaulted on their payment obligations in December 2020.

In July 2021, the Beijing Court ordered Tsinghua to commence reorganisation proceedings pursuant to the Enterprise Bankruptcy Law of the People's Republic of China. Citicorp commenced its claim against Tsinghua for its failure to perform its keepwell obligations under the keepwell deeds and EIPUs.

Tsinghua was found to have failed to use its best efforts to discharge its obligations and a monetary award (comprising principal amount of the bonds, accrued interest and certain of Citicorp's costs under the trust deed) was granted in favour of Citicorp.

### The Court's Decisions – Time is of the Essence

The PekingU Case and the Tsinghua Case were heard by Justice Harris in a back-to-back manner. While Justice Harris found that the facts of the two cases were "*remarkably similar*", the Court gave different rulings in the two cases on the basis of timing – whether default of the keepwell obligations took place **before or after** the keepwell provider's reorganisation proceedings in the PRC.

In the Tsinghua Case, the default occurred **before** the commencement of Tsinghua's reorganisation proceedings in the PRC, whereas in the PekingU Case, the default occurred **after** the commencement of PekingU's reorganisation proceedings in the PRC<sup>3</sup>. This timing was critical in determining whether the keepwell provider could have realistically used its best efforts to obtain regulatory approvals to comply with the relevant keepwell obligations at the time of its failure to perform them.

Salient points from the Court's reasoning in the PekingU Case and the Tsinghua Case are summarised below:

- Keepwell deeds and EIPUs are **binding and enforceable contractual obligations** which can be directly enforced against the keepwell providers. There is no public policy objection to the enforcement of such contracts.
- Keepwell providers are required to comply with their contractual obligations to **demonstrate best efforts in obtaining the necessary regulatory approvals** to perform their obligations under the keepwell deeds and EIPUs.
- If keepwell obligations are triggered **before** a keepwell provider is put into reorganisation, the keepwell provider **must prove that despite having used its best efforts, it could not obtain the necessary regulatory**

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<sup>2</sup> In one of the actions involving Founder Information (Hong Kong) Limited (**FIHK**, being one of the guarantors of the bonds) as the plaintiff, the Court found that PekingU's failure to perform its obligations to ensure that FIHK had a consolidated net equity of at least USD1 under the relevant keepwell deed occurred **before** the commencement of its reorganisation proceedings in the PRC.

<sup>3</sup> Except in FIHK's case, as mentioned above, where the breaches occurred before the commencement of PekingU's reorganisation proceedings in the PRC. A declaratory relief was therefore granted in favour of the plaintiff (i.e. FIHK).

**approvals for performing the keepwell obligations** in order to establish a regulatory approval defence for its non-performance.

- **Timing of the onshore reorganisation proceedings** is determinative of the plausibility of obtaining regulatory approvals. After a PRC company is put into reorganisation, it would be highly difficult to obtain the regulatory approvals necessary to make cross-border payments to its offshore subsidiaries.
- **Significant monetary award** (comprising the principal amount of the bonds, accrued interest and certain of the plaintiff's costs) could be awarded against keepwell providers upon breach of keepwell deeds and EIPUs. Such an award may be helpful in an enforcement action against a keepwell provider's assets in accordance with and subject to the law of the jurisdiction of enforcement.

## **Key Takeaways – Practical Insights from the Court's Decisions**

### ***Keepwell or No Keepwell***

The two landmark cases illustrate that keepwell deeds and EIPUs can be credit enhancement substitutes where guarantees are not commercially or legally practicable options. Compared to other forms of credit enhancement such as guarantees, keepwell deeds and EIPUs have been the less-preferred options for investors primarily due to the uncertainties surrounding their enforceability from a practical perspective. While the Court positively recognised the enforceability of keepwell deeds and EIPUs in both the PekingU Case and the Tsinghua Case, it also acknowledged the possibility of a regulatory approval defence in cases of non-performance by keepwell providers. As such, credit enhancement provided by keepwell deeds and EIPUs could still be significantly undermined, particularly in light of the fact that parties have no control over the timing of any intervening events such as the keepwell provider's reorganisation or insolvency proceedings.

Conducting thorough analyses of an issuer's actual needs and the market's risk appetite will continue to be fundamental in determining the transaction structure for each offshore bond transaction involving a PRC company.

### ***Importance of Legal Documentation***

In each of the PekingU Case and the Tsinghua Case, the Court conducted a detailed examination of the contractual provisions in the legal documentation.

The careful scrutiny by the Court serves as a timely reminder of the importance of proper documentation and adequate legal advice during the preparatory stage of an offshore bond issuance. While issuer groups must be properly advised as to their obligations under the relevant documents, contractual provisions must also be drafted in a way that caters for parties' operational needs throughout the tenor of the bonds. Various covenants and events of default, for example, will have to be carefully designed in the early stage of preparation.

### ***Continued Diligence after Issuance of the Bonds***

The very different outcomes in the PekingU Case and the Tsinghua Case highlight how early identification of breaches and prompt enforcement actions could significantly affect the outcome of enforcement actions against keepwell providers. This, in turn, begs the question of how parties are informed of a company's well-being after the bonds are issued.

Under the terms and conditions of the bonds, issuers, guarantors and keepwell providers would typically be required to furnish trustees with various types of information regarding their financial position and compliance status throughout the tenor of the bonds. Such information includes, among other things, periodic financial statements, compliance certificates and liquidity notices. In addition, trust deeds would typically require issuers, guarantors and keepwell providers to notify the trustees immediately upon becoming aware of any event of default, potential event of default or other triggering event without the need for trustees to take any further action.

Issuers, guarantors and keepwell providers are reminded of their obligations to provide the required information in a timely manner throughout the tenor of the bonds. In particular, non-compliance of such obligations could potentially lead to an event of default which gives trustees and bondholders the right to accelerate the bonds. If in doubt, issuers and trustees should consult their legal advisers.

## Want to know more?

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