

EXTERNAL IMPACT ON ARBITRATION:
COMPANY INSOLVENCY ON INTERNATIONAL ARBITRATION

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Arbitration is a means for resolving disputes between parties. Its output is an enforceable award. However, when the arbitration proceedings are hit by insolvency of a party, this is an external factor affecting the conduct of the proceedings. When this happens, the court or arbitral tribunal would need to think about whether to stay the arbitration proceedings, pending the outcome of the insolvency proceedings. This question is governed by the national laws. By illustrating with the approach in the laws of Hong Kong, taking into reference comparative situations in other jurisdictions, the article seeks to explore how this external factor affects arbitration and provide brief guidance for consideration by all involved in the arbitration.

Party Insolvency

In the modern commercial world, insolvency of companies can take place anywhere in any trade. It can occur in good times or in bad times. As in earlier time, insolvency was on the rise in the Hong Kong construction industry. This is perhaps a combined result of the economic downturn that Hong Kong has now managed to survive and the traditional way in which the construction industry has operated. Contractors in the industry commonly fund their operations by means of overdrafts and trade credits, and are usually paid in arrears. Yet, their undertaken activities inherently involve a high degree of risk. There are definite uncertainties in pricing by tendering which arise from the fact that works are being priced before construction commenced. As such, there is a shared belief that insolvency is more likely to occur in the construction industry than in many others.

In many jurisdictions, the court has a discretion to stay or restrain all further proceedings in any action or proceeding brought against a company when insolvency occurs. When companies are wound up, it may thus be necessary for the court or the arbitral tribunal to consider how to further proceed with the arbitration that has already begun or been initiated.

Further Proceedings in Arbitration

As an illustrative example, winding-up proceedings in Hong Kong are primarily governed by Parts V, VI and X of the Companies Ordinance (Cap32). Section 181 of the Companies Ordinance provides:

'181. Power to stay or restrain proceedings against company

At any time after the presentation of a winding-up petition and before a winding-up order has been made, the company or any creditor or contributory may –

- (a) where any action or proceeding against the company is pending in the Court of First instance or the Court of Appeal, apply to the court in which the action or proceeding is pending for a stay of proceedings therein;
- (b) where any action or proceeding against the company is pending in any court or tribunal other than the Court of First Instance or the Court of Appeal, apply to the Court of First Instance to restrain further proceedings in the action or proceeding, and the court to which application is so made may, as the case may be, stay or restrain the proceedings accordingly on such terms as it thinks fit.'

On the other hand, arbitrations in Hong Kong are governed by the Arbitration Ordinance (Cap 341). As set out in s 2AA thereof, the objective of the Arbitration Ordinance is to facilitate the fair and speedy resolution of disputes by arbitration without unnecessary expense. This objective to be achieved is based on the principles that:

- subject to the observance of such safe guards as are necessary in the public interest, the parties to a dispute should be free to agree how the dispute should be resolved; and
- the court should interfere in the arbitration of a dispute only as expressly provided by the Arbitration Ordinance.

As such, interference from the court, unless expressly provided, is in conflict with the well-accepted objective, principles and policy towards the conduct of arbitrations. Yet, in the case of winding-up, could and should arbitrations already commenced be restrained from further proceedings?

This is the very issue that was raised in the case of *Re UDL Contracting Ltd* [2000]

1 HKC 390 before Le Pichon J in the Court of First Instance. The case concerned an application on 10 December 1999 for an order restraining all further proceedings in arbitration until the conclusion of the hearing of a winding-up petition against the applicant company. The arbitration had commenced in September 1998 and pleadings closed on 23 August 1999. On 24 August 1999, a petition to wind up the applicant company was presented based on non-compliance with a statutory demand founded on a judgment debt of about HK\$900,000. On 7 December 1999, he proposed to make a default award against the applicant company in respect of its defence and counterclaim. It was in these circumstances that the application came before the court.

The application was made under s 181(b) of the Companies Ordinance, and in the course of submissions a key issue arose that required determination by the court, namely, whether an arbitration is an 'action or proceeding' within the ambit of s 181(b) of the Companies Ordinance thus giving the court jurisdiction in the matter.

In opposing the application, counsel for the respondent submitted that s 2AA of the Arbitration Ordinance effectively displaces s 181 of the Companies Ordinance. Thus, if an arbitration is on foot and the court is asked to interfere, then the court may interfere only within the confines of the provisions of the Arbitration Ordinance.

This submission was rejected by Le Pichon J who, after reviewing the objective and principles of the Arbitration Ordinance, said:

‘...it is in that context, ie how the dispute between the parties is to be resolved, that interference should be restricted. The decision of the Court of Appeal in *SOL International Ltd v Guangzhou Dong-Jun Real Estate Interest Co Ltd* [1998] 3 HKC 493 is entirely consistent with the approach set out above. It is to be noted that the question whether s 2AA displaces other ordinances such as s 181 of Cap 32 did not arise for determination. Accordingly the Court of Appeal’s observations as to the effect of s 2AA must be read with that in mind.’

Relying on the additional words 'in any court or tribunal ' which are contained in the Hong Kong provisions as compared with the parallel English as compared with the parallel English provision, Le Pichon J said in her judgment:

‘That would suggest that “proceeding” is not to be confined to court proceedings. Further as pointed out by Kelly J in *Re Vassal*, “proceeding” has been given a wider meaning in the cases referred to in his judgment and the view of Lord Simon [obiter in the House of Lords’ decision in *Herbert Berry Associates Ltd v Inland Revenue Commissioners* [1978] 1 All ER 161 appears to stand alone. “Action or proceeding” is also used in s 186. As will become apparent, arbitrations are encompassed in the automatic stay imposed by that section. The same meaning must therefore be accorded to s 181(b). For all these reasons, the wider interpretation is to be preferred. In my judgment, an arbitration is a ‘proceeding’ for the purposes of s 181(b) of Cap 32’.

Any creditor, contributory or the company may make an application under s 181 of the Companies Ordinance. In other words, the application may be made by persons other than the parties to the arbitration. As stated in *Re Oak Pitts Colliery Co* (1882) 21 Ch D 322, the purpose of this section is to maintain the status quo, to preserve the company’s assets and put all unsecured creditors on an equal footing.

It should further be noted that this section has to be read together with s 186 of the Companies Ordinance, which provides:

‘186. Actions stayed on winding-up order

When a winding-up order has been made, or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company except by leave of the court, and subject to such terms as the court may impose.’

These two sections complement each other. They share a common purpose save that the burden is different: prior to a winding-up order being made or provisional liquidator appointed, the burden is on the application to justify a stay. Obviously, there is a material difference in law and in effect between the presentation of a winding-up petition and the making of a winding-up order. This is of growing importance, particularly in times when winding-up proceedings are uncommonly abused and used as a tool for collecting disputed debts.

In her judgement, Le Pichon J read these two sections together and said in relation to s 186 of the Companies Ordinance:

‘There is little doubt but that s 186 extends to arbitrations. When a provisional liquidator assumes office, he takes over the control of the company and its assets. If proceedings by and against the company are to be continued, leave of the court must be obtained. In other words, no expenditure may be incurred without such leave. If [the respondent’s] submission regarding the effect of s 2AA is correct, it would mean that arbitrations to which a company is party remain unaffected by the appointment of a provisional liquidator. That plainly is not the case since ongoing proceedings need to be funded and it is the provisional liquidator who is in control.’

Thus, the mere presentation of the winding-up petition can have an impact on restraining further proceedings in arbitrations already commenced. This jurisdiction is within the discretion of the court.

In UK, the relevant laws is the 1986 Insolvency Act and the EU Regulation on Insolvency Proceedings (Reg. No.1346/2000). According to these, the appointed liquidator or receiver etc. is the legal representative of the company to continue the arbitration. If winding-up is compulsory, leave of the court is also required to continue the arbitration. This system is similar to that of Hong Kong as aforesaid and is in line with the international practices.

Exercising Discretion

These sections are intended to operate as a check upon proceedings that might operate to the prejudice of the creditors. As such, it is unlikely that the court would sanction anything which would be improper or contrary to the ordinary course of trade. In the exercise of the discretion, regard must be had to the primary object of winding-up, namely, the collection and distribution of the assets *pari passu* among unsecured creditors after payment of preferential debts. In the decision of *Attlee Investments Ltd v Lee Chun t/a Lee Chuen Furniture Co* [1983] HKLR 420, the Hong Kong Court of Appeal laid down the general principle applicable in these circumstances. Thus, it is of fundamental importance that the discretion of the court be exercised not for the benefit of any particular

creditor or creditors, but for the benefit of the general body of creditors so interested. Where a petition has been presented which might result in a winding-up or a scheme of arrangement, no creditor should gain priority over others of his or her class.

In the *UDL* case, it was the position of the applicant company that it could no longer fund the arbitration. The management accounts showed that its liabilities exceeded its assets and it had but a nominal amount of cash in its bank account. Yet, unless the arbitration was stayed, the applicant company would be in breach of the peremptory order. The likelihood was that it would not be allowed to pursue its counterclaim and, also, not even be in a position to properly defend the claim. The prejudice that would have been caused to the creditors was evident. Further, the applicant company was undergoing a restructuring process and a scheme of arrangement under s 166 of the Companies Ordinance was under formulation and review for sanction. In making an order that all further proceedings in the arbitration be restrained until the conclusion of the hearing of the petition to wind up the applicant company, Le Pichon J took into account the above factors and exercised discretion in favour of the applicant company. She held:

‘In the exercise of the court’s discretion under s 181(b) the test is whether substantial injustice will result if the arbitration is not stayed. It is inarguably in the interest of the company’s creditors and contributories that [the respondent’s] claim be properly defended and the counterclaim asserted. Against that I have to balance any potential prejudice to [the respondent].’

This seems also to be consistent with the approach in *Bowkett v Fuller’s United Electric Works Ltd* [1923] 1 KB 160 that, in the absence of special circumstances, a stay of proceedings may be granted pending the formulation of a scheme of arrangement.

Procedural Options

When a winding-up petition is presented, and before the winding-up order is made or a provisional liquidator has been appointed, it is necessary to consider whether the arbitration should still proceed or be stayed pending the outcome of the winding-up proceedings. An award obtained between the presentation of the petition and the making of the winding-up order does not normally have any benefit but would surely result in costs unnecessarily incurred.

Further, the date of commencement of winding-up is not the date when the winding-up order is made. A compulsory winding-up is deemed to commence at the time of filing the petition; a voluntary winding-up commenced at the time of passing the resolution for voluntary winding-up. As such, it has a significant impact to the conduct of the arbitration, affecting perhaps also the arbitrator, at least in two aspects. First, after commencement of winding-up, any disposition of the company's property other than one made by the liquidator is void unless the court orders otherwise. Second, creditors cannot enforce any judgment or orders, and, hence, awards, in the case of arbitration, obtained after the commencement of winding-up.

Consequently, in case of insolvency, it would be more prudent to deal with the issues of whether, and on what terms, and arbitration which has already commenced should proceed ahead or be otherwise restrained. If appropriate, an application to invoke the courts' jurisdiction to restrain the proceedings on such terms as the Hong Kong courts think fit should be considered. The relevant factors to be taken into account can be seen from the US case of *Vesta Fire Insurance Corp. v. New Cap Reinsurance Corp.* 244 BR 209 (SDNY 2000). In that case, the arbitration was ordered by the US court to stay pending the resolution of the insolvency proceedings before the Australia court.

Also, it should not be forgotten that, where the winding-up procedure is indeed an abuse of process, the court has the power to strike out such a petition as in the Hong Kong case of *Re First GNP Hong Kong Ltd* [1995] 2 HKC 380.

Conclusion

There is a discretion vested in the Hong Kong courts to restrain all further proceedings in an arbitration already commenced in Hong Kong pursuant to s 181 of the Companies Ordinance upon the mere presentation of a winding-up petition. Other jurisdictions have similar legal regulation. Thus, if a party to arbitration is facing winding-up, all involved in the arbitration should evaluate and consider the above procedure options.

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