

## Recent PRC court case puts the use of keepwell deed under scrutiny



### *Use of keepwell deeds put under the microscope*

The ongoing restructuring of the Peking University Founder Group ("**PKU Group**") has, for the first time in recent memory, put the use of keepwell deeds under judicial scrutiny before the PRC courts. Regardless of the eventual outcome of these developments, market participants should take these events as an opportunity to re-evaluate whether it is still appropriate or feasible to use keepwell deeds in future transactions.

### **The case**

The ongoing restructuring case involves the issuance of a super-short term commercial paper by the PKU Group, and of bonds by Nuoxi Capital Limited ("**Nuoxi**") and Kunzhi Limited ("**Kunzhi**") backed with the benefit of a keepwell deed provided by PKU Group. Pursuant to such keepwell deed, PKU Group undertook to (among other things) cause *"each of the Issuer and the Guarantor to have sufficient liquidity to ensure timely payment by each of the Issuer and the Guarantor of any amounts payable under or in respect of the bonds"*. PKU Group failed to repay the commercial paper on its maturity date, despite an extension of its tenor. On 14 February 2020, the Bank of Beijing applied to a PRC court for the initiation of a reorganisation procedure against PKU Group. Shortly after, both Nuoxi and Kunzhi also defaulted on their bonds.

It is during these proceedings that the PRC court cast doubt on the effect of the keepwell deed issued by the PKU Group.

### **What is a keepwell deed?**

When a party contracts with another, it is often that one party would seek protective measures from its counterparty. Such protective measures could take various forms, but perhaps the most popular and well-known form is the guarantee, which will often be granted by the ultimate legal and/or beneficial owner of a contracting party.

However, in practice there may be circumstances which may render the granting of a guarantee impractical or difficult. For example: the laws and regulations of the relevant jurisdiction of a party (such as the PRC) may dictate that certain special approval or other formalities must first be sought or complied with before an entity is permitted to grant a guarantee. Quite often, even if such approval is granted (which can be time consuming and is by no means always a certainty), the parties may have to expend additional time and effort to fulfill follow-up procedures – time and effort which may not always be palatable to the parties' commercial arrangements.

Whilst it will be difficult to trace the precise origin of a keepwell deed, we believe it is the desire for parties to achieve a compromise between a full guarantee and the lack of credit enhancement that helped conceive the keepwell deed.

The content of each keepwell deed will vary between transactions, but it would typically include an undertaking by the relevant parent entity to (among other things) procure that (a) the obligor (which is often a subsidiary of such parent entity) will remain solvent throughout the contractual term and will perform its obligations under the relevant contracts, (b) such parent entity shall remain as the sole or majority beneficial owner of the obligor, and (c) such parent entity shall, by whatever means appropriate, ensure that the obligor will have sufficient resources to comply with its obligations under the relevant contract.

Regardless of a keepwell deed's actual content, we have found that the central theme would generally remain the same: that a keepwell deed is, at its core, a set of contractual undertakings which aim to provide a sense of comfort to the recipient party (indeed we have worked on transactions whereby the parties expressly demand that the relevant document be called a letter of comfort). It is not intended to be a guarantee (whether for English or Hong Kong law purposes) and, as we have seen from this PKU Group case,

its overall effectiveness (or possibly the effectiveness of a particular clause or undertaking with a keepwell deed) may be challenged as far as PRC law is concerned.

## Practical implications

Regardless of the final outcome of the ongoing PRC court proceedings mentioned above, it is possible that in the future we may see a reduced (and eventual cessation of) use of keepwell deeds in transactions.

Depending on the nature of an underlying transaction, however, there are other options that parties can consider as credit enhancement measures in lieu of a full guarantee or a keepwell deed. For example: it is not uncommon in a sale and purchase transaction whereby the buyer would demand that the parent company of the seller to have a buy-back obligation, such that if the relevant conditions are met, then the parent must buy-back the underlying asset at a pre-agreed price which would typically be calculated to present a genuine pre-estimate of the losses that the buyer would have suffered.

Another example is often found in the asset finance world, whereby the owner of an asset would enter into a standby lease agreement with the parent of the lessee, such that if anything adverse were to effect the initial lease between the owner and the lessee, then the parent would be obliged to take on the lease of the asset and pay rent to the owner at a rate which is at least at the same level as the initial lease. The purpose of this is to ensure the owner will always have a steady rental income stream, which will be critical to the owner if the owner has arranged its own borrowing to finance the acquisition of the asset.

## Conclusion

With the use of keepwell deeds being cast into doubt, commercial parties should consider viable alternative credit protection measures which are both commercially palatable and also legally and contractually robust. The last thing one should do is to treat a keepwell deed to have the same legal and credit enhancement effect as a guarantee.

## Get in touch



**Elton Chan**  
Partner  
T: +852 2533 2726  
Email: [Elton](#)



**James Wong**  
Associate  
T: +852 3166 6933  
Email: [James](#)

© Stephenson Harwood LLP 2020. Any reference to Stephenson Harwood in this document means Stephenson Harwood LLP and/or its affiliated undertakings. The term partner is used to refer to a member of Stephenson Harwood LLP or a partner, employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Stephenson Harwood LLP's affiliated undertakings.

Full details of Stephenson Harwood LLP and or/its affiliated undertakings can be found at [www.shlegal.com/legal-notices](http://www.shlegal.com/legal-notices).

Information contained in this email is current as at the date of first publication and is for general information only. It is not intended to provide legal advice.