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Rare Earth - careful planning is needed to ensure schemes of arrangement have their intended effect

In the matter of Rare Earth Magnesium Technology Group (provisional liquidators appointed) (for restructuring purposes only) [2022] HKCFI 1686 (date of judgment: 6 June 2022)

The Hong Kong Court has recently sanctioned a scheme of arrangement for Rare Earth Magnesium Technology Group (provisional liquidators appointed) (for restructuring purposes only) (**Rare Earth**). The case helpfully sets out the established principles for considering whether to sanction a scheme. Whilst not relevant to the facts of Rare Earth, the Court also used the opportunity to clarify whether foreign schemes will have the desired effect in Hong Kong.

Background

Rare Earth is part of a wider group whose business involves the development and production of green fertilisers with production bases in Jiangsu and Jiangxi Provinces, and the production of magnesium in the Jilin Province and Xinjiang Uyghur Autonomous Region. The group's financial position deteriorated in 2020 due to the COVID-19 pandemic. Rare Earth appointed soft-touch provisional liquidators (**PLs**) in Bermuda in mid-2020 to assist and facilitate a debt restructuring. Those PLs were recognised by the Hong Kong Court

shortly thereafter. The Company and the PLs pursued a debt restructuring which led to a scheme of arrangement being put forward in Hong Kong.

The scheme compromised the principal debt of interest-bearing bonds (governed by HK law). The total indebtedness was around HKD852 million which was owed to 10 scheme creditors. Under the terms of the scheme the creditors were given a choice between either or a combination of (i) a term extension option; and (ii) a convertible bond swap option. Scheme creditors who had already agreed to the terms of the restructuring were given a consent fee in cash amounting to 3% of the principal amount of debt owed by Rare Earth to the scheme creditors.

Convening orders for the scheme were made on 12 January 2022. The first creditors meeting was held on 15 February 2022. Some amendments were made resulting from negotiations with a major creditor. At the adjourned creditors meeting on 1 March 2022, 79.06% of the creditors voted in favour of the scheme terms (representing 9 out of the 10 scheme creditors). The matter then went before Justice Harris at the second court hearing for sanction by the Court.

Relevant principles for sanction of schemes

In considering whether to sanction the scheme, the Court applied the following well-established principles:[1]

1. whether the scheme is for a permissible purpose;
2. whether creditors who were called on to vote as a single class had sufficiently similar legal rights such that they could consult together with a view to their common interest at a single meeting;
3. whether the meeting was duly convened in accordance with the Court's directions;
4. whether creditors have been given sufficient information about the scheme to enable them to make an informed decision on whether or not to support it (i.e. whether the explanatory statement included all of the necessary information to enable the creditors to form a reasonable judgment on whether the scheme is in their best interest);
5. whether the necessary statutory majorities have been obtained;
6. whether the Court is satisfied in the exercise of its discretion that an intelligent and honest man acting in accordance with his interests as a member of the class within which he voted might reasonably approve the scheme; and
7. in an international case, whether there is a sufficient connection between the scheme and Hong Kong, and whether the scheme is effective in other relevant jurisdictions.

In the decision, Justice Harris walks through the above principles applying the facts of the Rare Earth case, the terms of the restructuring deal contained in the scheme, and the process undertaken by the PLs in explaining the scheme, convening and holding the creditors meeting. It is therefore a helpful illustration of what needs to be complied with to ensure a scheme receives Court sanction.

A small modification was also sought to the scheme terms to deal with the SEHK's comments on the structure of the share placement scheme. The Court permitted these modifications (even though they were

[1] *Rare Earth* at [17], also citing *Re China Singyes Solar Technologies Holdings Ltd* [2020] HKCFI 467.

made after the creditors meeting) because they improved the scheme creditors' recovery and would not prejudice any scheme creditors.

An order was made sanctioning the scheme.

Are parallel schemes necessary for transnational cases?

In the decision, Justice Harris made some obiter comments that a scheme sanctioned in an offshore jurisdiction (i.e. the jurisdiction of incorporation of the company) and recognised under Chapter 15[2] in the US will not be treated by a Hong Kong court as compromising USD debt.

The Rule in *Gibbs* provides that a debt is treated as discharged if it is compromised in accordance with the law of the jurisdiction which governed the law of the debt. Chapter 15 does not operate as a compromise or discharge of the US governed debt. Rather Chapter 15 operates procedurally to recognise foreign insolvency processes and prevent actions by a creditor against the company's property in the US. This is a distinction which advisors need to be alert to when dealing with cross-border restructuring cases. Therefore, an offshore scheme, recognised in the US, will not bind a creditor (in Hong Kong) who did not participate in the foreign scheme process.

Justice Harris pointed to the structure used in the 2016 *Winsway*[3] case as an effective method for ensuring compromise of the debt. A Stephenson Harwood team acted for the debtor company Winsway. In that case the US law governed debt was effectively compromised with parallel schemes in Hong Kong and BVI. The Hong Kong scheme was recognised in the US as a "foreign non-main proceeding" ensuring that creditors could not take any enforcement action in Hong Kong.

So, if a company has any creditors who could present a petition to wind up the Company in Hong Kong, a parallel Hong Kong scheme of arrangement may be necessary.

This was not in issue in *Rare Earth* because the Hong Kong scheme put forward was only compromising Hong Kong law governed debt. That is, the *Rare Earth* scheme would be recognised abroad (at least in those countries which follow the Rule in *Gibbs*).

Takeaway points

Careful planning is essential when companies or their financial advisors are planning to compromise debt obligations via schemes of arrangement.

It is important to ensure the compromise is effective in all relevant jurisdictions. Despite a recent trend to effect schemes in the offshore jurisdiction of incorporation with recognition in the US, it may still be necessary (depending on the creditor body) to use a parallel scheme in Hong Kong. There is no one size fits all structure. It is imperative to consider the location of creditors (in particular, any minorities who may not consent to the proposed restructuring terms) and the governing law of the relevant debts. We can help companies and their financial advisors with such planning.

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[2] Chapter 15, 11 United States Bankruptcy Code § 1501
[3] *Re Winsway Enterprises Holdings Ltd* [2017] 1 HKLRD 1.

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