

Client Alert

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Setting aside a statutory demand on grounds of an arbitration agreement in Hong Kong – Lasmos case put into question but survives another day

The Court of Appeal (CA) recently dismissed an appeal to set aside a statutory demand arising out of the failure to pay margin calls in *But Ka Chon v. Interactive Brokers LLC* (02/08/2019, CACV 611/2018) [2019] HKCA 873, despite the presence of a mandatory arbitration clause. Obiter comments of the CA put into question the recent case law in *Re Southwest Pacific Bauxite (HK) Ltd* [2018] 2 HKLRD 449 (the “**Lasmos case**”) that a petition should “generally be dismissed” in the face of a mandatory arbitration clause.

Some key points


1. The appellant/debtor failed to set aside the statutory demand under the Bankruptcy Ordinance (Cap. 6) in the Court of First Instance (“CFI”). In both the CFI and the CA, he argued that the debt was disputed on substantial grounds and the statutory demand should be set aside on the following grounds:
 - a. he relied on misrepresentations to enter into the Customer Agreement with the creditor brokerage firm and therefore had a cross-claim for the net liquidation value of his brokerage account; and
 - b. as there was a substantial dispute, this should have been arbitrated pursuant to the mandatory arbitration clause in the contract.

Notwithstanding that Justice Jonathan Harris’ *Lasmos* decision was handed down after the CFI hearing, the CFI Judge directed the parties to file supplemental skeletons to address *Lasmos*. The CFI and the recent CA decisions discuss *Lasmos* (which was discussed in our earlier Client Alert - see [Alert](#)).

The CFI Position

2. Deputy Judge Kent Yee noted that where *Lasmos* suggested that a petition to wind up a company on insolvency grounds should “generally be dismissed” without having to show that the petition debt is bona fide disputed on substantial grounds, it ‘made a substantial departure from previous authorities at first instance in Hong Kong’ instead opting for the English Court of Appeal’s approach in *Salford Estates (No 2) Ltd v Altomart Ltd (No 2)* [2015] Ch 589.
3. Under the *Lasmos* approach, the petition should generally be dismissed if the three requirements are met:
 - (1) the company disputes the debt relied on by the petitioner;



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- (2) the contract giving rise to the debt contains an arbitration clause that covers any dispute relating to the debt; and
 - (3) the company takes the steps required under the arbitration clause to commence the contractually mandated dispute resolution process (which might include preliminary stages such as mediation); and files an affirmation in accordance with r.32 of the Companies (Winding-up) Rules, Cap 32H to demonstrate their commencement of arbitration ("**Arbitration Steps**").
4. The CFI judge found the debtor/appellant's misrepresentation claim to be meritless when refusing to set aside the statutory demand. He also noted that the debtors' earlier letters did not amount to a notice of arbitration as required under contract. Thus *Lasmos* was '*inapplicable in any event*' as the appellant failed to take the Arbitration Steps.

The CA Position

5. The CA unanimously agreed with the CFI judge's findings of fact and that the third requirement of *Lasmos* has not been complied with, as 'it would make no sense to dismiss or stay an insolvency petition on the mere existence of an arbitration agreement where the debtor has no genuine intention to arbitrate'.
6. Kwan VP of the CA noted that it was unnecessary to decide whether the approach in *Lasmos* (decided in the context of winding-up petitions) should be adopted in an application to set aside a statutory demand. But given the importance of the issue, she made some obiter comments which were unanimously endorsed by the CA bench:
- a. there is no automatic or mandatory stay under the arbitration legislation. Staying or dismissing a petition where the alleged debt arises out of a transaction containing an arbitration agreement is discretionary and this was the pre-*Lasmos* position.
 - b. in *Lasmos*, Justice Harris decided that such discretion should be exercised only one way: the petition should "generally be dismissed" save in "exceptional" or "wholly exceptional" circumstances, upon satisfaction of the three requirements (see paragraph 1 above and our earlier client alert on *Lasmos* for examples of 'exceptional' circumstances).
 - c. Kwan VP commented that it is contrary to public policy to preclude or fetter the exercise of the statutory right to wind-up or bankrupt a party for insolvency. The *Lasmos* approach may be a substantial curtailment of the creditors' statutory right.
7. Kwan VP acknowledged that considerable weight should be given to the arbitration agreement in the exercise of the discretion and it may well be that insufficient weight had been given to the arbitration factor pre-*Lasmos*. But the court should not be powerless where creditors may be applying improper pressure. Nor did she think that the discretion should invariably be exercised in favour of granting a winding-up or bankruptcy order where the court is satisfied there is no bona fide dispute on



substantial grounds, thereby putting an end to any arbitration proceedings.

What it means for you and actions to be taken

1. For insolvency practitioners, the case demonstrates the Hong Kong Court's pro-activeness in considering new case law, drawing cross-references taken from insolvency and bankruptcy case law (notwithstanding that there is no equivalent to setting aside a statutory demand for companies winding-up), from its own jurisdiction and other common law jurisdictions, e.g. England & Wales and the British Virgin Islands.
2. The position taken by Kwan VP is consistent with the pre-*Lasmos* position (where there is an arbitration clause) and the general position when setting aside petitions for winding-up or bankruptcy scenarios, namely, that an opposing debtor is required to prove there is '*a bona fide defence on substantial grounds to the underlying debt*' to set aside a petition or the statutory demand under r.48(5) of the Bankruptcy Rules (Cap.6A); and
3. Given the comments by the CA, the future treatment of *Lasmos* remains to be seen. Debtors should seek prompt legal advice to:
 - a) determine if there may be a '*bona fide and substantial dispute*' over the debt as opposed to a mere dispute subject to a mandatory arbitration clause, and
 - b) ensure the Arbitration Steps are complied with in a meaningful way to demonstrate there is a genuine intention to arbitrate.

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