

Legal Commentary

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Dispute Resolution Law

Guarantee or Independent Contract? — The Nature of Keepwell Deeds under PRC Law and Remedies for Breach

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The Shanghai Financial Court recently recognized a judgment¹ rendered by a Hong Kong court, which has become a widely watched development. The judgment originated from a lawsuit filed by a Hong Kong investment fund against a Shanghai company arising from a keepwell deed the Shanghai company provided for offshore bonds issued by its overseas affiliate. It was also previously reported that in a bankruptcy reorganization case the receiver rejected the creditor claims of certain bondholders that were based on the keepwell deed of a well-known Beijing company, which had offered the deed for bonds issued by its overseas subsidiary. Against this background, the Shanghai court's recognition of this judgment may to some extent alleviate anxiety in the financial industry concerning the effectiveness of keepwell deeds. While there is yet to be a published PRC court judgment addressing the nature and effectiveness of keepwell deeds, this issue and related questions such as foreign bond investors' remedies based on keepwell deeds under PRC law remain a worthwhile topic for discussion.

Legal discussions regarding keepwell deeds mostly focus on the relationship between keepwell deeds and guarantees. The conclusions drawn are highly consistent – a keepwell deed does not constitute a guarantee. In recent years, asset management product defaults have increased and disputes arising from credit enhancements have emerged in quick succession, such as third-party commitments to repay the balance of the agreed proceeds under the asset management products. Third-party credit enhancements are generally not structured as guarantees, given the unique legal structure of asset management products and the fear that the authorities could deem such products as guaranteeing principal and return on investment (which is prohibited by law). As such, PRC courts have generally viewed these arrangements as independent contracts as opposed to guarantees. Relevant judicial

¹ [2019] Hu 74 Ren Gang No. 1.

rulings concerning independent contracts are reflected in the Minutes of the National Court Work Conference for Civil and Commercial Trials (“**Ninth Civil and Commercial Minutes**”)², a highly authoritative guideline on judicial practice. In light of this, it is necessary to reexamine – from the perspective of independent contracts – the nature and effectiveness of the keepwell deed and judicial remedies available to foreign bondholders in China.

In sum, a keepwell deed, as a third-party credit enhancement, may be recognized as an independent contract under PRC law. Where bonds mature or are declared mature and the party providing the keepwell deed (“**Keepwell Party**”) fails to perform under the deed, the bondholders – if not fully paid – may directly request the Keepwell Party to compensate for the bondholders’ resulting losses (by way of making up the balance of repayment), or commence a subrogation action against the Keepwell Party, demanding it to pay the bondholders the amount it should have paid to the issuer/guarantor for breach of the deed.

What a keepwell deed is and why it exists

Keepwell deeds generally refer to a type of credit enhancement document that PRC companies provide for the issuance of offshore bonds. A keepwell deed is generally signed jointly by the PRC company, the bond issuer, the guarantor, and the trustee (see Figure 1 for a typical bond issuance structure involving keepwell deeds). Such deeds typically stipulate, among other things, that the PRC company undertakes to procure that the issuer and the guarantor have adequate liquidity to repay the bonds upon maturity and that they maintain a certain level of net assets. Many keepwell deeds are also accompanied by an equity interest purchase undertaking (EIPU)³ or the undertaking of liquidity support⁴. Keepwell deeds often express that they “shall not be deemed a guarantee.”

² See Article 91 of the Ninth Civil and Commercial Minutes. “[Nature of Credit Enhancement Documents] Where the parties concerned which are not under a trust contract provide similar undertaking documents such as the third party making up the balance of repayment, performance of matured buyback obligations on behalf, liquidity support, etc. as credit enhancement measures, and the contents thereof comply with the provisions of the laws on guarantees, the People’s Court shall rule that a guarantee contract relationship is concluded between the parties concerned. If their contents do not meet the requirements of a guarantee, the corresponding relationship of rights and obligations shall be determined in light of the specific contents of the commitment documents, and the corresponding civil liabilities shall be determined in light of the facts of the case.”

³ It is generally stipulated that the Keepwell Party undertakes to purchase the equity of the issuer or the guarantor’s subsidiary in order to provide the issuer or the guarantor with sufficient capital to repay the bond when the issuer and guarantor default.

⁴ It is generally stipulated that the Keepwell Party undertakes to provide loans and other support to the issuer or the guarantor to repay the bond when the issuer and the guarantor defaults.

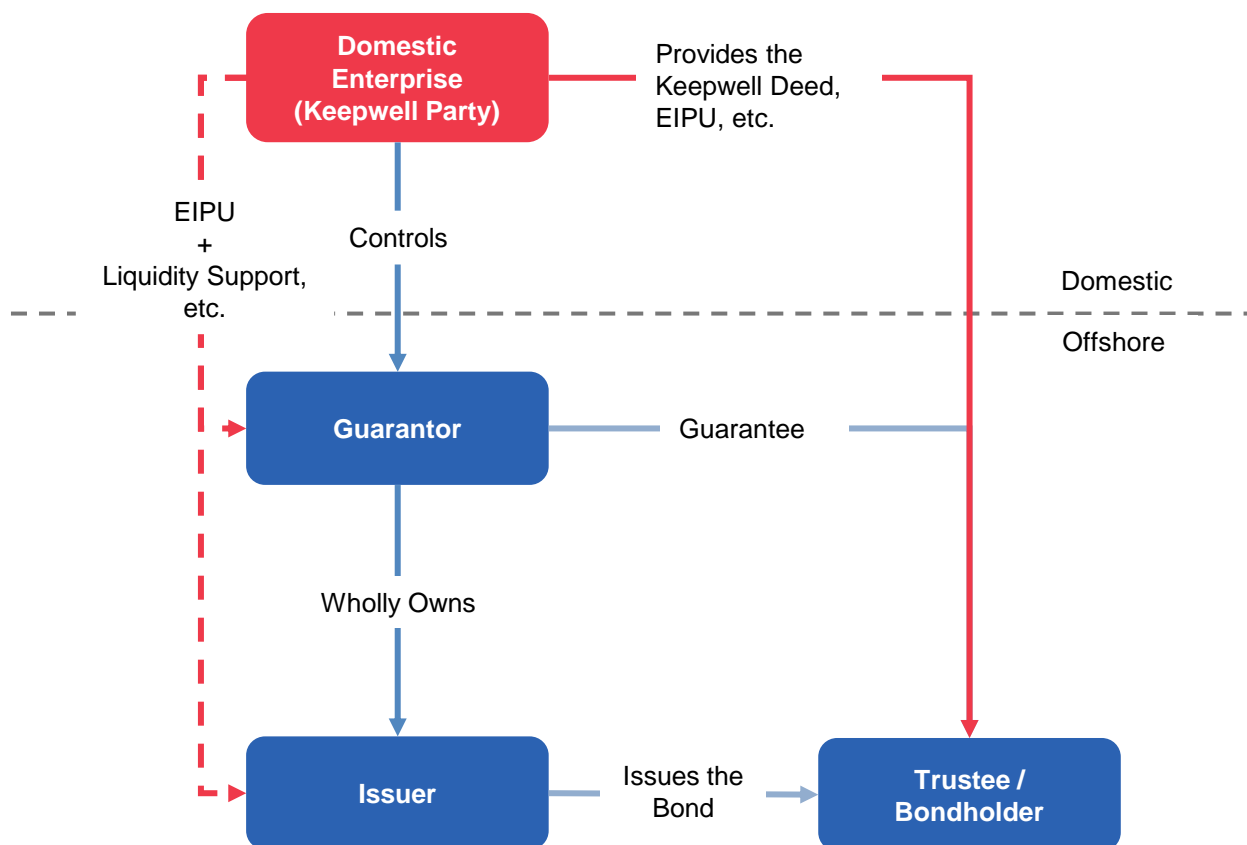


Figure 1: Typical bond issuance structure involving keepwell deeds

It is generally believed that keepwell deeds began to be adopted for offshore bond issuances in 2012 to bypass certain limitations PRC companies confronted when attempting to directly issue or guarantee bonds in offshore markets. Previously, when PRC companies wished to directly issue bonds in offshore markets, they had to obtain potentially burdensome approvals from the National Development and Reform Commission (“**NDRC**”) and even the State Council⁵. If an issuer wished to otherwise “indirectly” issue offshore bonds, i.e., guaranteeing bonds issued by their offshore subsidiaries, they would have to complete registration formalities with the State Administration of Foreign Exchange (“**SAFE**”) and satisfy corresponding regulatory requirements. Moreover, funds raised by their subsidiaries in this way could not be remitted back to the PRC companies/guarantors but instead could only be used for overseas projects in which they had equity interests⁶. By contrast, keepwell deeds provided by PRC companies are not subject to NDRC or SAFE supervision⁷ and can thus pave the way for conducting offshore financing. For

⁵ See Article 2 of the Notice of the National Development and Reform Commission on Matters concerning Issuance of RMB Bonds by Domestic Non-financial Institutions in the Hong Kong Special Administrative Region, Fa Gai Wai Zi No. [2012]1162 (国家发展改革委关于境内非金融机构赴香港特别行政区发行人民币债券有关事项的通知, 发改外资[2012]1162号); Article 2(2) of the Circular of the General Office of the State Council on Issuing the Proposals of the State Development Planning Commission and the People’s Bank of China on Enhancing the Administration of the Issuing of Bonds on Overseas Markets, Guo Ban Fa No. [2000]23 (国务院办公厅转发国家计委、人民银行关于进一步加强对外发债管理意见的通知, 国办发[2000]23号).

⁶ See Article 11 of the Provisions on Foreign Exchange Administration for Cross-border Guarantees, Hui Fa No. [2014]29 (跨境担保外汇管理规定, 汇发[2014]29号).

⁷ See Part 4, Article 5 of Operational Guidelines for Foreign Exchange Administration of Cross-border Guarantees, Hui Fa No. [2014]29 (跨境担保外汇管理操作指引, 汇发[2014]29号).

this reason, PRC companies have widely adopted keepwell deeds in offshore bond issuances.

Viewing keepwell deeds as guarantees

Our research of public sources has not revealed any decision in which a PRC court ruled on the nature or effectiveness of a keepwell deed. That said, disputes over other credit enhancements are not uncommon. PRC court rulings on such enhancements may still suggest their view as to whether keepwell deeds constitute guarantees.

Under PRC law, a guarantee refers to a guarantor's promise to a creditor to assume the debtor's obligation and liability when the debtor defaults. On this basis, a guarantee must "attach" to a principal debt; by performing a guarantee, the guarantor is effectively performing the debtor's obligation to the creditor with respect to the debt. Any commitment without this characteristic does not constitute a guarantee. In determining whether a commitment constitutes a guarantee, a court will look to the wording of the commitment and see whether it explicitly demonstrates a party's intent to perform the debtor's obligation in the case of default.

In the case [2004] Min Si Zhong Zi No. 5 (which the Supreme People's Court (the "SPC") has compiled into its gazette, a non-binding but highly persuasive authority), the SPC maintained that where a third party unrelated to the loan agreement issued a letter of commitment to the creditor without clearly stating it would guarantee repayment, the letter of commitment would not be deemed a guarantee under the PRC Guaranty Law. In [2014] Min Si Zhong Zi No. 37, concerning a guarantee contract dispute, the SPC denied that the letter of commitment at issue satisfied the requirements of a guarantee under Article 6 of the PRC Guaranty Law, as the Government of Liaoning Province issued that document without expressing an intent to satisfy the debts of the debtor. The government instead stated only that it would provide "*assistance*" in repayment of the debts. In [2011] Min Shen Zi No. 1412, concerning a guarantee contract dispute, the Guangzhou Bureau of Foreign Trade and Economic Cooperation issued a letter of commitment to overseas creditors. The SPC held that the letter of commitment did not constitute a guarantee as it did not specify the bureau's intent to guarantee payment of the loan by the debtor. Instead, the document merely stated the bureau's commitment to urge the debtor to faithfully and timely repay the principal and interest on the loans, and to resolve problems and prevent creditors from suffering economic losses if the debtor defaulted on its obligations.

Given the above, whether a keepwell deed constitutes a guarantee ultimately depends on whether the deed manifests an express intent to perform the issuer's obligations. PRC courts are not likely to treat keepwell deeds as guarantees under the PRC Guaranty Law, considering that the Keepwell Party's commitment is generally not to repay the bonds for the issuer/guarantor but rather to maintain the issuer/guarantor's capability to repay such bonds, and that a keepwell deed usually states that it "shall not be deemed a guarantee⁸."

⁸ The USD Bond CEFCIG 5.950% 25Nov2018 contains a description of the keepwell deed in the offering circular that includes "[t]he Keepwell Deed is not, and nothing therein contained and nothing done pursuant thereto by the Company shall be deemed to constitute, a guarantee by the Company of the payment of any obligation, responsibilities, indebtedness or liability, of any kind or character whatsoever, of the Issuer or the Guarantor under the laws of any jurisdiction."

Keepwell deeds as independent contracts

While not being regarded as guarantees by PRC courts, keepwell deeds nonetheless do not constitute ordinary comfort letters or merely impose non-binding moral obligations on the Keepwell Party.

A typical keepwell deed usually states that it “shall not be deemed a guarantee.” However, it also usually requires the Keepwell Party to perform certain seemingly binding obligations. Take for example the keepwell deed in the offering circular of a USD bond – the Keepwell Party’s undertakings include but are not limited to holding a certain proportion of shares of the issuer and the guarantor and maintaining the net worth of the issuer and the guarantor as well as their liquidity and solvency⁹. Other keepwell deeds for USD bonds contain similar provisions¹⁰. In light of this, the assertion that a keepwell deed merely imposes non-binding moral obligations on the Keepwell Party contradicts the principle of interpreting a contract based on its plain wording.

Article 91 of the Ninth Civil and Commercial Trial Minutes further indicates that a credit enhancement could be binding even where it does “*not meet the requirements of a guarantee.*” Courts must still determine the rights and obligations of the parties based on the wordings of the documents. In respect of keepwell deeds, courts must determine the rights and obligations of the Keepwell Party and the counterparty based on the content of the keepwell deed. When doing so, reference could be made to prior judicial decisions on asset management disputes, in which courts have frequently ruled that a “*commitment to make up the balance of repayment constitutes an independent contract.*” A typical form of such a commitment usually provides that a third party often promises to pay the investor the difference between the amount the investor should have received and that which it actually received.

Prior judicial decisions on such commitments reveal that creditors were entitled to request the promisor to make up the balance of repayment when the creditors were not fully paid upon the automatic or declared maturity of the bonds. Depending on its content, courts may deem such a commitment a guarantee, an accession to indebtedness (meaning that a third party to the contract actively assumes a party’s contractual obligations jointly with that party), or an independent contract. If a commitment explicitly manifests the promisor’s intent to guarantee the loan and the commitment meets the requirements of a guarantee, it is likely to be deemed a guarantee. The court may also deem the commitment to be a guarantee where such intent is not explicitly demonstrated but the commitment is made for the debtor’s interest. By contrast, if the commitment is not made for the debtor’s interest, the court may find it constitutes an accession to indebtedness to the extent of the balance of repayment. Where the content of the “commitment to make up the balance of repayment” is not identical to but only in parallel with the debtor’s obligation under the contract, such commitment may be deemed an independent contract.

For instance, in [2018] Zui Gao Fa Min Zhong No. 127, concerning a contract dispute, the plaintiff had

⁹ See <https://www.bondsupermart.com/main/file-depository/download-file?paramCategory=bondDocument¶mDocumentNo=3572>, last accessed on November 17, 2020.

¹⁰ For example, GRNCH 5.650% 13Jul2025 (link: <https://www.bondsupermart.com/main/file-depository/download-file?paramCategory=bondDocument¶mDocumentNo=4996>, last accessed on November 17, 2020); CCBL 1.990% 21Jul2025 (link: <https://www.bondsupermart.com/main/file-depository/download-file?paramCategory=bondDocument¶mDocumentNo=4970>, last accessed on November 17, 2020); GUAMET 1.507% 17Sep2025 (link: <https://www.bondsupermart.com/main/file-depository/download-file?paramCategory=bondDocument¶mDocumentNo=5174>, last accessed on November 17, 2020).

entered into an asset purchase agreement with the purchaser on the transfer to the purchaser of shares in the target company. Pursuant to the agreement, the purchaser was to pay the plaintiff a bonus if the target company achieved a performance commitment. At the same time, the defendant issued a letter of commitment to the plaintiff, setting forth that if the target company failed to achieve the performance commitment and rendered the plaintiff unable to receive the bonus, the defendant would pay an amount to the plaintiff equivalent to that of the bonus. The SPC found that the obligations under the letter of commitment were parallel to, rather than attached to, those under the asset purchase agreement. Therefore, when the payment condition under the letter of commitment was triggered (i.e., the target company's performance failed to reach the committed level), the defendant (the promisor) was obligated to pay the unreceived bonus to the plaintiff.

Another example is [2019] Zui Gao Fa Min Zhong No. 1524, which concerned a commercial trust dispute. In this case, natural person A granted a loan to company B in the name of a trust. A and the controller of B entered into an agreement on making-up the balance of repayment and transfer of beneficiary rights. Under this agreement, should B fail to fully perform its payment obligations, the controller is obliged to pay A the balance of the trust principal in conjunction with 13% annualized interest and to purchase from A the corresponding trust beneficiary rights. The SPC found that the controller's obligations under this Agreement did not guarantee the debts of B. Instead, the agreement was an independent and effective contract that manifested the genuine intent of the parties and complied with mandatory provisions of law. Therefore, the controller was obligated to make up the aforesaid balance and purchase the trust beneficiary rights from A.

Keepwell deeds could be regarded as "commitments to make up the balance of repayment" to bondholders, the issuer, or the guarantor. Such deeds were devised to help PRC companies raise funds overseas by bypassing certain domestic regulations and restrictions. They provide for Keepwell Parties' commitment to maintaining the liquidity and solvency of its overseas subsidiaries serving as issuers or guarantors, so that bondholders can receive the balance of payments due that issuers/guarantors are unable to repay on their own. This is similar to a "commitment to make up the balance of repayment" discussed above. Given the aforementioned judicial decisions, keepwell deeds are likely to be deemed independent contracts as they neither directly require Keepwell Parties to make payments to bondholders nor manifest the intent of Keepwell Parties to repay bonds for issuers/guarantors.

Remedies bondholders may obtain from PRC courts

Given that PRC courts may treat keepwell deeds as independent contracts, bondholders can pursue the following court remedies when an issuer/guarantor defaults and the Keepwell Party also fails to perform its obligations under the keepwell deed. First, bondholders can request the court to terminate the bond subscription/issuance agreement as well as the keepwell deed and to hold the issuer, the guarantor, and the Keepwell Party jointly and severally liable for the bondholders' losses. Second, bondholders can also commence a subrogation action against the Keepwell Party, demanding it to pay the amount it should have paid to the issuer/guarantor for breach of the deed.

1. Request the issuer, the guarantor, and the Keepwell Party to jointly and severally compensate for the bondholders' losses

This remedy derives from Keepwell Parties' obligations owed to bondholders. As mentioned above, a keepwell deed is usually signed jointly by the trustee (on behalf of the bondholders), the issuer, the guarantor, and the Keepwell Party. Also, an offering circular may set out that bond issuance documents including the trust deed and the keepwell deed apply to bondholders, which makes each bondholder a party to those documents.

Although Keepwell Parties' commitments typically target issuers and guarantors (for example, the provision of liquidity support), they are actually made and performed for the benefit of bondholders. Thus, bondholders should be the counterparties of these commitments. If an issuer/guarantor defaults and the Keepwell Party fails to fulfill its commitments, bondholders may directly request the issuer, the guarantor, and the Keepwell Party to jointly and severally compensate the bondholders' losses resulting from their breach. The amount of losses should be equivalent to the balance of the principal and interest to be received by the bondholders¹¹.

It is worth noting that the legal basis for the issuer, the guarantor, and the Keepwell Party to bear liability in this manner is not a joint-and-several guarantee (as discussed above, a keepwell deed is not generally deemed a guarantee). In PRC judicial practice, this kind of joint and several liability is usually called "disguised joint and several liability." It means – according to prior SPC decisions – each of the multiple debtors is required to fully perform similar obligations due to *different* reasons and such obligations would be wholly extinguished by any of the debtors' full performance¹². Under this theory, each debtor becomes liable for its own – as opposed to someone else's – breach. The creditor has *independent* claims against each of the debtors. When an issuer/guarantor defaults and the Keepwell Party meanwhile breaches the keepwell deed, bondholders would have separate claims for losses against the issuer/guarantor based on bonds and against the Keepwell Party based on the deed. The total amount of such claims would be equivalent to the balance of the principal and interest to be received by the bondholders. Thus, the issuer, the guarantor, and the Keepwell Party are not genuinely severally and jointly liable to the bondholders as each of their breach has to be established, as opposed to a genuine joint and several liability under which only one party's breach has to be established. In other words, the issuer, the guarantor, and the Keepwell Party's bearing of liability in this manner has only the pretext (and not the nature) of joint and several liability.

2. Initiate a subrogation action against the Keepwell Party

This remedy derives from the Keepwell Parties' obligations owed to the issuers/guarantors. When an issuer/guarantor defaults, bondholders would have a claim to demand repayment of the bond principal

¹¹ For example, the offering circular for USD bonds CHMINV 3.800% 02 Aug2021. "Noteholders (as defined below) and the holders of the related interest coupons, if any, (the "Couponholders" and the "Coupons", respectively) are bound by, and are deemed to have notice of, all the provisions of the Trust Deed, the relevant Deed(s) of Guarantee, the Keepwell and Liquidity Support Deed, the Deed of Equity Interest Purchase Undertaking and the Agency Agreement applicable to them." (link: <https://www.bondsupermart.com/main/file-depository/download-file?paramCategory=bondDocument¶mDocumentNo=1649>, last accessed on November 17, 2020).

¹² See, for example, [2014] Min Min Zhong Zi No.266; [2014] Min Shen Zi No.1589.

and interest. In the meantime, as the Keepwell Party had failed to perform under the keepwell deed, the issuer/guarantor would also be entitled to request the Keepwell Party to, among other things, provide liquidity support and/or inject capital to the issuer/guarantor.

Under the PRC Contract Law¹³ and its judicial interpretation¹⁴, if an issuer/guarantor fails to pursue its claims against the Keepwell Party, bondholders could directly claim against the Keepwell Party on behalf of the issuer/guarantor, requesting the Keepwell Party to pay the bondholders the amount the Keepwell Party should have paid to the issuer/guarantor due to breach of the keepwell deed. In particular, merely giving notice to the Keepwell Party to perform its obligations is not sufficient for the issuer/guarantor to avoid triggering the bondholders' right of subrogation. Instead, the issuer/guarantor must at least initiate litigation or arbitration against the Keepwell Party. Moreover, in a subrogation action, the Keepwell Party will bear the burden of proving that the issuer/guarantor has actively pursued its claim against the Keepwell Party¹⁵. If the Keepwell Party is in bankruptcy proceedings, the bondholders may also declare their subrogation claims to the receiver (depending on the probability of success in the subrogation action).

Obstacles caused by forum selection clauses and solutions

In practice, the dispute resolution clause of a keepwell deed typically provides for the exclusive jurisdiction of overseas courts (such as courts of Hong Kong or the United Kingdom). When bondholders wish to seek damages from the Keepwell Party, they must first obtain a favorable judgment rendered by the overseas court, then apply to a competent PRC court for recognition and enforcement of the judgment against the Keepwell Party. If the keepwell deed provides for the exclusive jurisdiction of a UK court, it would be difficult for bondholders to enforce such a judgment before PRC courts due to the lack of a treaty or a precedent on mutual recognition of civil judgments between China and the United Kingdom.

That said, if the Keepwell Party has entered bankruptcy proceedings, claims against the Keepwell Party – whether for direct damages or a subrogation – should be filed with the court before which the bankruptcy proceedings are conducted, regardless of the forum selection clause¹⁶. In such case, the bondholders may under such circumstance obtain meaningful and enforceable remedies from the court in charge of the

¹³ Article 73 of the Contract Law reads, “[i]f a debtor causes losses to the creditor concerned by being indolent in exercising its matured claims, the creditor may apply to the competent people’s court to subrogate the debtor to exercise the latter’s claims under the creditor’s name, except for claims that belong exclusively to the debtor.”

¹⁴ Article 11 of the Interpretation I of the Supreme People’s Court on Several Issues concerning the Application of the Contract Law of the People’s Republic of China sets forth that, “[w]here a creditor is to institute an action of subrogation pursuant to Article 73 of the Contract Law, the following requirements shall be satisfied: (1) The creditor’s right against a debtor is lawful; (2) A debtor’s indolence to exercise the matured claims as a creditor harms the creditor’s interest; (3) The creditor’s claims are matured; and (4) A debtor’s right as a creditor is not a creditor’s right exclusive to the debtor.”

¹⁵ Article 13 of the Interpretation I of the Supreme People’s Court on Several Issues concerning the Application of the Contract Law of the People’s Republic of China sets forth that, “[f]or the purposes of Article 73 of the Contract Law, the provision ‘a debtor causes losses to the creditor concerned by being indolent in exercising its matured claims’ shall mean that a debtor neither performs the debtor’s due obligation toward a creditor nor asserts against its debtor a matured claim which involves the payment of money either through a lawsuit or through arbitration, thereby frustrating the realization of the creditor’s due right. Where the secondary debtor (i.e. the debtor of the original debtor) denies the existence of the original debtor’s indolence to exercise the matured claims, the secondary debtor shall bear the burden of proof.”

¹⁶ Article 21 of the Enterprise Bankruptcy Law of the People’s Republic of China sets forth that, “[a]fter the people’s court accepts a petition for bankruptcy, civil actions concerning the debtor may only be brought in the people’s court that accepts the petition for bankruptcy.” See also [2020] Ji Min Zhong No. 659.

bankruptcy proceedings despite the forum selection clause granting exclusive jurisdiction to the UK court.

If the Keepwell Party does not enter bankruptcy proceedings, bondholders subject to such a forum selection clause may consider a subrogation action as the preferred option, because judicial interpretations provide that a subrogation action is subject to the jurisdiction of the court at the defendant's domicile¹⁷. Such a provision would prevail over the forum selection clause between the parties¹⁸.

¹⁷ Article 14 of the Interpretation I of the Supreme People's Court on Several Issues concerning the Application of the Contract Law of the People's Republic of China sets forth that, "[w]here a creditor institutes an action of subrogation pursuant to Article 73 of the Contract Law, the action shall be under the jurisdiction of the people's court of the place where the defendant is domiciled."

¹⁸ See [2018] Zui Gao Fa Min Xia Zhong No.107. The Supreme People's Court held that the court's jurisdiction over the subrogation action against the creditor is a special kind of territorial jurisdiction provided by judicial interpretations, and its effect prevails the agreement between the parties.

Important Announcement

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