# Arbitration agreements and insolvency proceedings

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## Introduction

Recently, the British Virgin Islands has seen a trend wherein debtors involved in winding-up proceedings have sought to identify what appear to be spurious disputes and then to rely on arbitration clauses in order to strike out or stay the winding-up proceedings. While this tactic could be regarded as capitalising on the wider global trend towards giving absolute primacy to arbitration agreements, it is often deployed to buy time for debtors and frustrate creditors that are legitimately seeking to wind up insolvent companies.

In two key recent decisions the Eastern Caribbean Court of Appeal examined attempts by debtors to rely on the mandatory stay provisions in the BVI arbitration legislation in order to avoid liquidation. On both occasions it came down decisively against the debtors, which were unable to show a substantive dispute to the debt.

Winding-up proceedings are collective in nature and the court confirmed that they are not an 'action' under the new BVI Arbitration Act 2013 (which attracts an automatic stay simply because a dispute has been raised by the debtor). Importantly, this decision signalled a move away from the English position, so that a creditor need not show 'exceptional circumstances' in order for the court to exercise its discretion to wind up a company notwithstanding the existence of an arbitration clause. The court will exercise its discretion based on whether a dispute based on genuine and substantive grounds exists. In a welcome move for lenders and creditors, the Eastern Caribbean Court of Appeal has brought clarity to the situation and closed the door on a potentially abusive practice.

## Need for substantial dispute

In *C-Mobile Services Ltd v Huawei Technologies Co Limited* (BVIHCMAP 2014/0006 and BVIHCMAP 2014/0017) the respondent company sought to wind up C-Mobile, a mobile telecommunications operator in the Ivory Coast, Gambia and (formerly) Liberia and incorporated in the British Virgin Islands, on the basis of a debt arising under a supply contract.

After a statutory demand had been served, C-Mobile applied to set this aside on the mandatory grounds of a substantial dispute as to whether the debt was owing or due. One of the asserted grounds of dispute was the existence of an arbitration clause in the supply contract. However, it did not seek to set aside

the statutory demand in the alternative on discretionary grounds (ie, the court can set aside a statutory demand if it is satisfied that substantial injustice would otherwise be caused).

The application to set aside the demand was dismissed, with the first-instance judge applying the well-known *Sparkasse* test[1] and finding that there was no substance to the alleged grounds of dispute. After Huawei filed an originating application to appoint liquidators, C-Mobile then applied to stay the winding-up proceedings under Section 6(2) of the (now repealed) Arbitration Ordinance,[2] relying again on the arbitration clause in the supply contract.

At the hearing of the stay application, the first-instance judge dismissed the application, finding – among other things – that winding-up proceedings were not a matter "agreed to be referred" under the arbitration clause and, as such, winding-up proceedings fell outside the scope of the arbitration clause.

**Mandatory or discretionary stay?**

On appeal, the emotive thrust of C-Mobile's argument was that it was entirely wrong for Huawei to bypass the parties' chosen method of dispute resolution and seek to wind up the company. In this regard it relied heavily on the English Court of Appeal case of *Salford Estates (No 2) Ltd v Altomart Ltd (No 2)* [2015] 3 WLR 491.

In that case, the chancellor held that while winding-up proceedings are 'legal proceedings' as defined by Section 82 of the (English) Arbitration Act 1996, the mandatory stay provisions in Section 9(1) did not apply to a winding-up petition where the grounds of the petition were that the company could not pay its debts.[3]

However, in relation to the court's wide discretionary power to make a winding-up order, the chancellor stated that, save in exceptional circumstances, the court should exercise its discretion consistently with the legislative policy embodied in the English Arbitration Act 1996. The chancellor concluded that the first-instance court had been right either to dismiss or stay the winding-up petition in order to compel the parties to resolve their dispute over the debt by arbitration.

Although the Eastern Caribbean Court of Appeal was in "full agreement" with the views expressed in*Salford Estates*, it made three material observations regarding the case:

- The arbitration clause in the supply contract was confined to "disputes arising out of or in connection with the formation, construction and performance of this contract"; it was thus considerably narrower in scope than the arbitration clause in *Salford Estates* (which covered "any dispute or difference arising between the Lessor and the Lessee as to their respective tights, duties or obligations or as to any other matter arising out of or in connection with this underlease").
- The court had already ruled on the question of whether the debt was disputed on substantial grounds and found that it was not. In this regard, when the company had applied to set aside the statutory demand, it had done so on the mandatory grounds set out in Section 157(1) of the Insolvency Act 2003 and not the discretionary grounds set out in Section 157(2).

- The arbitration proceedings which had been commenced by C-Mobile were no longer afoot.

Ultimately, the court agreed with the first-instance judge's conclusion that the dispute fell outside the arbitration clause and therefore there was no basis for compelling the parties to arbitrate. The appeal was accordingly dismissed.

**Interfacing with new BVI Arbitration Act**

Less than two months after handing down its judgment in *C-Mobile*, the Eastern Caribbean Court of Appeal revisited the issue of the interface between arbitration clauses and winding-up proceedings in *Jinpeng Group Limited v Peak Hotels and Resorts Limited* (BVIHCMAP 2014/0025 and BVIHCMAP 2015/0003).

On September 18 2014 the appellant filed an originating application to appoint liquidators over the respondent (on the basis that it was both a present and prospective creditor) and an ordinary application to appoint joint provisional liquidators. The respondent then filed an ordinary application for an order striking out the originating application.

On September 25 and 26 2014 the appellant's ordinary application was heard and the first-instance judge appointed joint provisional liquidators. The first-instance judge then heard the strike application. At the hearing, the first-instance judge concluded that the debt was disputed and accordingly struck out the originating application and ordered the discharge of the joint provisional liquidators.

Since the first-instance judge decided that there was no substantial dispute, he did not have to consider the respondent's alternative application to stay the proceedings for arbitration. On appeal, the Eastern Caribbean Court of Appeal held that the first-instance judge had incorrectly applied the*Sparkasse* test (ie, of whether the debt is disputed on genuine and substantial grounds), instead applying a test with a lower standard.

Having reached this conclusion, the Eastern Caribbean Court of Appeal had to consider the issue concerning the effect of arbitration clauses in the documents on which the debt was founded. The material difference between *Jinpeng* and *C-Mobile* was that in *Jinpeng* the dispute was covered by the relevant arbitration clauses. Further, *Jinpeng* was determined under Section 18(1) of the Arbitration Act 2013, which had come into effect from October 1 2014.

Section 18(1) of the Arbitration Act 2013 covers all disputes that are the subject of an arbitration agreement between the parties, providing as follows:

> "*A court before which an action is brought in a matter which is the subject of an arbitration agreement, shall, if a party so requests not later than when submitting his first statement on the substance of the dispute, refer the parties to arbitration unless it finds that the agreement is null and void, inoperative or incapable of being performed*."

**Collective proceedings**

The court observed that, even though the application to wind up had been brought on just and equitable grounds alleging misconduct, it was still a creditor's application seeking a collective remedy on behalf of the applicant

creditor and all other creditors of the respondent (a point emphasised in *C-Mobile*). In this regard, it was distinct from a claim by the appellant to recover a debt from the respondent, which would be a dispute between contracting parties. As winding-up proceedings are not an 'action' covered by arbitration clauses in agreements (designed to resolve disputes between contracting parties) or Section 18(1) of the Arbitration Act 2013, the court should not grant an automatic stay of the application just because the respondent has raised a dispute over the appellant's status (ie, as a creditor) to apply for a winding-up order.

**Exceptional circumstances or substantive dispute?**

However, the court confirmed that this was not the end of the matter, since the existence of an arbitration clause was relevant to how the court should exercise its discretion to wind up. In this regard, the court clearly rejected the English law requirement (following *Salford Estates*) that a creditor must prove exceptional circumstances in order for the court to exercise its discretion to make a winding-up order – the reason being that under BVI law, the court's statutory jurisdiction to wind up a company is based on the latter's inability to pay its debts as they fall due, unless the debt is disputed on genuine and substantial grounds.

The court commented that this principle is:

> "*too firmly a part of BVI law to now require a creditor exercising the statutory right belonging to all the creditors of the company to apply to wind up the company, to prove exceptional circumstances to establish his status to apply*."

Therefore, the appellant must show that the dispute is not on genuine and substantial grounds and leave it to the court to exercise its discretion under Section 162 on the usual basis. The effect of these decisions is to curtail the ability of debtors from relying on arbitration clauses to defeat applications to appoint liquidators.

The Eastern Caribbean Court of Appeal has delivered a welcome blow against the practice of companies raising spurious disputes and hiding behind arbitration clauses to defeat winding-up proceedings.

**Endnotes**

(1) *Sparkasse Bregenz Bank AG v Associated Capital Corporation* (BVIHCVAP2002/0010, June 18 2003).

(2) Cap 6, Revised Laws of the Virgin Islands 1991.

(3) Section 122(1)(f) of the (UK) Insolvency Act 1986.