IN CHAMBERS
IN THE GRAND COURT OF THE CAYMAN ISLANDS

CAUSE NO. 38 of 2004.

BETWEEN KTH CAPITAL MANAGEMENT LIMITED PLAINTIFF

AND CHINA ONE FINANCIAL LTD.

MSP CHINA HOLDINGS LIMITED

MS/KTH ADVISORY CORP LIMITED

ZHONGJIN FENGDE HOLDINGS LIMITED DEFENDANTS

CORAM: HARRISON J (Ag)

Appearances:

Mr. J. Walton and Mr. J. Tarboton of Appleby Spurling Hunter for the Plaintiff.

Mr. Neil Timms instructed by Mr. James Eldridge of Maples and Calder for the First Defendant.

Dates of hearing: 28th, 30th June & 27th July 2006

JUDGMENT

The Mareva Injunction Application

1. The plaintiff filed this application on the 21st April 2006 seeking an order for the grant of a Mareva injunction against China One (the first defendant) in order to restrain it from dealing with the value of its net or unencumbered assets below Eight Million Dollars (US$8M).
2. The applicant says that it has a good arguable case against the first Defendant and that unless the injunction is granted, it will be unable to recover judgment against the first defendant in the action filed.
3. There is one basic question of law to determine in this matter and it is this: On the basis that the plaintiff has a good arguable case, should a company be

restrained from distributing all its remaining assets to shareholders where it has no intention of leaving anything to meet the plaintiff's claim?

The background facts

4. In late 2001, a number of entities including MSR Capital Ltd ("Morgan Stanley"), Salomon Brothers Holding Company Inc, Lehman Brothers Opportunity Holdings Inc, KTH CM and, later, International Finance Corporation (together called the "Consortium") agreed to collaborate in bidding for and, if successful, to service and enforce a number of tranches of non-performing loans (NPLs) that were being auctioned off by an affiliate of the Industrial and Commercial Bank of China.

5. The bid tendered by the Consortium was largely successful and the parties set up a joint venture company known as China One Financial Limited ("China One") to hold their investment. China One in turn entered into a joint venture contract with the seller, China Huarong Asset Management Company ("Huarong"), to establish First United Asset Management Company ("First United") as the entity to acquire the NPLs. As part of the structure, a PRC asset management company ("Kaili") was established to assist in realising the NPL's.

6. The plaintiff, KTH CM, at all material times was the recorded holder of 17.46% of the shares in China One. However, there is an ongoing dispute with KTH Investments Limited ("KTHI"). KTHI has alleged that it was defrauded out of being the 17.46% shareholder by KTH CM and KTHI has accordingly filed an application to rectify the share register of China One.

7. A Shareholders Agreement for China One was signed by the shareholders on March 12, 2003.

8. In August 2004, allegations were made by KTHI's director that KTH CM had defrauded the other Consortium members through the manufacturing of fraudulent invoices. In response, the Consortium, led by Morgan Stanley, removed KTH CM's directors from the board of the asset servicing company ("Kaili") and excluded KTH CM from any further participation in the Huarong deal.

9. As a result of this decision by Morgan Stanley, KTH CM instituted proceedings in the Grand Court of the Cayman Islands against China One and other parties seeking specific performance of the various Kaili contracts and, in the alternative, damages.

10. The damages claimed by KTH CM against China One have been calculated and particularised in KTH CM's Particulars of Damages as amounting to US$7.8 million.

The jurisdiction to grant a mareva injunction

11. The jurisdiction to grant a Mareva injunction is well established. In **Mareva Cia Naviera SA v International Bulkcarriers SA, The Mareva (1975)** [1980] 1 All ER 213, the English Court of Appeal considered the general principle of respectable antiquity expressed in **Lister v Stubbs** (1890) 45 Ch. D. 1 (1886-90) All E.R. Rep. 797, to the effect that the Court has no jurisdiction to protect a creditor before he obtains judgment. Nevertheless, it was held that the jurisdiction conferred by Section 45 of the English Supreme Court (Consolidation) Act 1925, was sufficiently wide to confer jurisdiction to grant an interlocutory injunction:

> "If it appears that the debt is due and owing, and there is a danger that the debtor may dispose of his assets so as to defeat it before judgment, the Court has jurisdiction in a proper case to grant an interlocutory judgment so as to prevent him disposing of those assets. It seems to me that this is a proper case for the exercise of this jurisdiction."

Parker LJ in *Derby v. Weldon [1990] 1 Ch. 48* at 57 F – G said:

> "It is no part of the court's function at this stage of the litigation to try to resolve conflicts of evidence on affidavit as to facts in which the claims of either party may ultimately depend nor to decide difficult questions of law which call for detailed argument and mature considerations. These are matters to be dealt with at the trial. One of the reasons for the introduction of the practice requiring an undertaking as to damages upon the grant of an interlocutory injunction was that 'it aided the court in doing that which was its great object, viz. abstaining from expressing any opinion on the merits of the case until the hearing': *Wakefield v. Duke of Buccleugh* (1865) 12 LT 628, 629."

The test

12. It is now settled law that to obtain a Mareva Injunction the plaintiff must demonstrate that -

(i) in so far as the merits of his proposed action are concerned he has a 'good arguable case'. **See Ninemia Corp v Trave Schiffahrts** [1983] 2 Lloyds L.R 600;

(ii) the defendant has no or insufficient assets within the jurisdiction to satisfy the plaintiff's claim and there are assets without the jurisdiction and;

(iii) that there is a real risk of dissipation or secretion of those assets so as to render any judgment which he might obtain nugatory.

13. In addition, the Court will consider the broad justice of the case and, in particular, the prejudice which the grant of the Mareva Injunction may cause to the defendant.

14. The classic formulation of this test is set out in the judgment of Mustill J in **Ninemia Maritime** (supra) at 603 – 605. In particular, at 605 the judge held:

> "In these circumstances I consider that the right course is to adopt the test of a good arguable case, in the sense of a case which is more than barely capable of serious argument, and yet not necessarily one which the Judge believes to have better than 50 per cent chance of success."

Resolving the issues

15. In resolving the questions raised in this application I gave careful consideration to the history of the proceedings, the issues in contention and the specific factors and special circumstances upon which the application for the injunction rests. I considered all the evidence placed before me in order to make a correct determination of the risk of dissipation.

16. The submissions (both written and oral) have been extensive and a number of days were spent hearing the application. I did not include all the contents of the submissions in this judgment but it is not intended to be disrespectful to Counsel. I have nevertheless considered them very carefully in addition to the several affidavits and documents exhibited. I shall now proceed to examine the bases of the plaintiff's application.

Good and Arguable Case

17. The allegations supporting the claim against the first defendant are that it is taking steps (1) to extract all value from the company and distribute this to its shareholders, of whom the majority shareholder is Morgan Stanley and; (2) to

wind down the operations of China One and its PRC subsidiaries ("First United" and "Kaili"). Mr. Walton, Counsel for the applicant submitted that this decision by China One has had the effect of reducing the company's assets. He also submitted that the principal indicator of this distribution of assets is China One's recent borrowing of US$27 million from Standard Chartered Bank ("SCB") in order to fund the distributions to shareholders.

18. According to Mr. Walton, the expert report of Mr Ken Krys, has indicated that this distribution has caused China One to be balance sheet insolvent taking into account the claim by KTH CM of US$7.8 million plus interest and costs. The latest management accounts of China One, he said, show that the company has net shareholders equity of US$7.6 million after distribution of the dividends to shareholders, an amount insufficient to meet KTH CM's claim in full.

19. Mr. Walton further submitted that the borrowing by China One was not necessary to fund its business operations, since its sole purpose appears to be to provide the means to make advance return to shareholders without having to wait for the actual collection of the NPLs. This borrowing he said, has imposed an unnecessary financing burden on China One.

20. Mr. Walton also submitted that the evidence in this case discloses that KTH CM has a good, even strong prima facie case that (1) the Defendants have breached their obligations under the Form Agreement to enter into and abide by the nine Kaili contracts; (2) KTH CM has suffered significant loss as a result; and (3) the Defendants' pleaded excuse for not complying with their obligations under the

Form Agreement, namely that KTH CM has been involved in an unrelated fraud, is neither relevant nor true.

21. Mr. Walton also submitted that there is no dispute that China One has assets in the form of its own cash at a Hong Kong bank and an (as yet unrealised) investment in First United. However, unless an injunction is obtained, it is clear he said, that China One intends to pay as much of its profits as possible to its shareholders by way of dividend distribution.

22. The question to be considered therefore is whether these allegations provide the plaintiff with a good arguable case?

23. Mr. Timms for the First Defendant contends on the other hand, that there is no ground at all for a Mareva Injunction to be granted and that it is not probable that the plaintiff will succeed in its action. He has contended that the order for a mareva injunction would have the effect of prohibiting China One from making payment to its shareholders in the ordinary course of business.

24. Mr. Timms further submitted that the application by KTH CM is based largely on "unsourced and fallacious information" which was founded on reported rumours that assets have been secretly sold at an undervalue with the intention of closing the business down prematurely. He argued that it was a "misunderstanding and mischaracterisation of a loan transaction and payment to shareholders and an inaccurate assessment of the financial position of China One".

25. Mr. Timms also submitted that the delay on the part of the applicant in applying for the mareva injunction is a relevant consideration for the court. He submitted

that an applicant must not sleep on its rights and that the delay here is not excusable.

The risk of dissipation of assets

26. The burden of proof lies upon the plaintiff to establish that there is a real risk of dissipation. What is the evidence adduced by the plaintiff in discharge of this burden?

27. Mr. Walton submitted that the test is readily satisfied in the present factual circumstances, where the expert evidence shows that China One's present assets (including its unrealised investment in First United) are insufficient to meet its liabilities. Furthermore he argued that China One has applied for a reduction of capital in order to enable further funds to be distributed to China One (and on to shareholders) but no provision was made for KTH CM's US$7.8 million (plus interest and costs) claim to be reflected in China One's accounts.

28. Mr. Walton submitted that the evidence shows firstly that there is a winding down of the operations of the first defendant and its PRC subsidiaries ("First United" and "Kaili") and that the principal indicator of this is the first defendant's recent borrowing of US$27 Million from Standard Chartered Bank ("SCB") in order to fund distributions to shareholders. Secondly, the appellant's expert report shows that this borrowing has had the effect of making the defendant "**balance sheet insolvent**".

29. The applicant further contends that the amount owing to it will ultimately be irrecoverable if the first defendant is allowed to continue to strip the assets away.

Mr. Timms on the other hand, submitted that the first defendant's investment in First United is conservatively recorded in its financial statements and that the loan from "SCB" was simply obtained as bridging finance to assist in extracting cash from First United and not for any sinister purpose. He submitted that in light of the evidence produced on behalf of the first defendant the basis of the application is unsustainable.

30. Mr. Timms relied heavily upon the affidavit evidence of Neill Poole sworn to on June 16, 2006. He is Managing Director of Alvarez & Marsal Asia Limited in Hong Kong and he leads "A&M" Dispute Analysis and Forensics team in Asia. Among other things, he is also a member of the Institute of Chartered Accountants in England and Wales. He also specializes in forensic accountancy work. The opinions that he says have been expressed in the Report represent his true and complete professional opinion, and lie within his field of expertise.

31. At paragraph 9 he states:

> "I have been provided with a copy of China One's audited financial statements for the year ended 31 December 2005 (which were not available to Mr. Krys at the date of his report) (Annexure 3). He has stated that based on the information he has had on the litigation with KTHCM it is apparent that the Directors of China One do not in their judgment, consider the claim by KTHCM will be successful and therefore a successful claim is not considered "probable". Consequently, under FAS 5, I consider it appropriate that China One did not accrue a liability in its financial statements for the year ended 31 December 2005".

32. At paragraphs 13, 14 and 15 respectively, Mr. Poole states:

> "13. In paragraph 2.32 of the Krys Report Mr. Krys concludes that China One "would appear to be balance sheet insolvent(i.e the company's liabilities exceeded its assets) at March 22, 2006" based

on his analysis and assumptions, including his adjustment of China One's actual asset position to take account of a liability of US$7.8M in respect of the claim by KTHCM.

14. With respect to Mr. Krys, I consider his analysis is flawed and his conclusion incorrect. In fact, Mr. Krys has treated the contingent liability as "probable", under the definition of FAS 5, both in terms of the claim by KTHCM being successful and in terms of the quantum of the claim being US$7.M. Mr. Krys has implicitly concluded that the judgment of the directors of China One, their legal advisers and China One's auditors is incorrect without offering any justification for doing so.

15. In my experience, when considering whether a company is insolvent using the "balance sheet test" a contingent liability which is classed as "reasonably possible" or "remote" would not be taken into account in determining the net assets or net liabilities of a company".

33. Mr. Timms further submitted that China One exists for one business purpose - that of being a conduit for the proceeds of realisation of the NPL's to be passed from First United to China One's shareholders and onwards to the ultimate investors. What the Plaintiff seeks to do he said, is to interfere or prevent that business purpose being achieved. It is abundantly clear also, he said, that there is overwhelming evidence that the plaintiff and its controllers perpetuated a fraud on the first defendant and the Morgan Stanley companies.

The undertaking as to damages

34. Mr. Timms submitted that at the least, the inability to give an adequate undertaking as to damages is a factor to be taken into account in the exercise of the Court's discretion should the Applicant achieve the thresholds set out above.

35. He submitted that when a party applies for a freezing order, one of the requirements it must address is the ability to service a cross undertaking in damages. Such an undertaking he said, must normally be given and there are no

exceptional circumstances in this case to show why an undertaking should not be given. He submitted that save in exceptional circumstances, the applicant must put in evidence indicating its financial status and indicating it has sufficient assets adequately to cover the costs of the undertaking.

36. Mr. Timms further argued that in this case the Applicant has neither offered an undertaking nor produced evidence as to its means to service it. He submitted that even if an undertaking were to be offered or required, it would be worthless since the Applicant is a shell company. He said that its controllers are outside the jurisdiction and it would not be sufficient to say that funds are held in an account for the shareholder and could be used to support an undertaking because those funds may not belong to the Applicant but may belong to KTHI.

37. Mr. Walton submitted in response that the submissions made by Mr. Timms are wrong in law. He said China One could suffer no damages because a company that is restrained from distributing dividends would suffer no financial loss and would gain financially on the other hand. He further submitted that there was no need for the plaintiff to supply evidence in relation to its ability to give an undertaking as to damages. In any event, Mr. Walton offered to provide an undertaking as to damages in the ordinary way, but without security by way of fortification.

Analysis of the evidence and conclusion

38. The facts of the proceedings before me are extensive and complicated but as I have already pointed out in this judgment, that it is no part of my function at this stage to resolve conflicts of evidence on affidavits as to facts.

39. Mr. Timms submitted that both Li and Wang, Directors of KTH CM were participants in the fraud perpetuated upon China One. He argued that the International Risk Report describes the fraudulent transactions committed by both Directors. These are serious allegations of fraud but they also will have to be determined at a trial.

40. I am most grateful to the plaintiff's Attorneys for bringing the case of **Consolidated Constructions Pty Ltd v Bellenville Pty Ltd.** [2002] FCA 1513 to my attention. In that case the Australian Federal Court dealt specifically (at paragraphs 17 to 30) with the issue of whether or not a special purpose vehicle's payment of dividends may be restrained by injunction if done in the ordinary course of that company's business or projected business.

41. The evidence presented by the plaintiff in the instant case has revealed that the first defendant borrowed the sum of US$27 Million from SCB in order to distribute dividends to its shareholders. The probabilities are that such a business proposition could no doubt have been engaged by the first defendant irrespective of whether these proceedings had been commenced but as Brennan J., observed

however in **Jackson v Sterling Industries Ltd** (1987) 162 CLR at 621, "the schemes which a debtor may devise for divesting himself of assets are "legion".

42. Of course, this is not to say that the ordinary course of the respondents' business is an irrelevant factor when one comes to decide whether or not a mareva injunction ought to be granted. It is indeed a relevant factor for consideration by the Court in particular, when assessing the degree to which the making of a mareva order would intrude on the carrying on of the company's business.

43. The dicta by Carr J in **Consolidated Constructions Pty Ltd v Bellenville Pty Ltd.** (supra) is however useful where he stated:

> "The authorities show that such orders are moulded to interfere as minimally as possible with the carrying on of a business of a party against whom such an order is made. In the case of an individual, similar concerns are recognised by provision being made for ordinary living expenses and the like. The difference here, as I see it, is that the Buxton and Babcock groups want to bring the first respondent's business to an end and take all of its assets, by way of dividends, at a time before its legal rights and obligations have been finally determined".

44. In my judgment, I have concluded that restraining a company by mareva injunction from distributing dividends does not prejudice the operations of the company itself and neither does it affect the company's business as such. The only prejudice it might have is to the shareholders because they will not receive these dividends. I do agree with Mr. Walton that the interests of the shareholders are quite irrelevant in this application.

45. After weighing the above factors, the applicant in my view has established that there is a serious question to be tried. The evidence presented, clearly indicate that

this Court has the jurisdiction and power to grant the mareva injunction sought. The borrowing of large sums of money for the payment of dividends to shareholders would certainly have the effect of rendering any judgment obtained by the applicant in the Action ineffective, and unless the first defendant is restrained, its assets might be dissipated outside the reach of the Court.

46. It is further my view that the $27M indebtedness imperils the first defendant's financial position since that debt would have had to be paid before any judgment debt can be satisfied.

47. The mareva injunction is therefore granted pursuant to Order 29 rule 1 of the Grand Court Rules with the usual undertaking as to damages. There shall be costs of this application to the plaintiff to be taxed if not agreed.

JUSTICE KARL S. HARRISON
JUDGE OF THE GRAND COURT (Acting)

Judgement released on behalf of Justice Harrison, except for the last sentence in relation to costs which is reserved until Justice Harrison will have heard submissions of the parties in that regard.

The formal order to await his final determination.

GRAND COURT CAYMAN ISLANDS

Hon. Anthony Smellie
Chief Justice