# People's Republic of China

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The long-awaited enactment of the ninth draft of the Enterprise Bankruptcy Law has been delayed. Unlike the current bankruptcy legislation, which comprises numerous different laws and rules, the draft law is a unified law intended to apply to all private and state-owned enterprises. The draft law has many of the characteristics of bankruptcy regimes found in established market economies, and includes reorganisation and conciliation, as well as provisions (albeit vague) on cross-border insolvency.

The delay has been caused by disagreements over social and economic issues raised by certain core provisions. Until these are resolved and the draft law is adopted, the current bankruptcy law and rules continue to apply.

The People's Republic of China is a civil law jurisdiction. Creditors' rights are enforced through a court system which has not had much experience of handling sophisticated market-driven creditors' rights issues. The independence of the courts has also been questioned. The system is marred by local protectionism and is inconsistent throughout the country. Legal remedies are therefore not certain. It is believed that legal remedies are easier to obtain if they are applied for in more 'sophisticated' cities or provinces, such as Beijing, Shanghai or Shenzhen. However, there have been some improvements to the legal system: certain provinces have made a concerted effort to train judges (who are generally not legally qualified), and the court system has been overhauled in recent years.

Creditors and investors may wish to insulate themselves from the current uncertainties of the PRC legal system by structuring their investment through offshore entities.

## 1. Legal framework and the effectiveness of court processes/legal remedies

### *1.1 Describe the nature and effectiveness of the following:*

#### *(a) Debt recovery remedies where the creditor has no security*

A creditor may ask a competent court to issue a payment order against the debtor if the following conditions are met:

- The creditor's claim involves only the repayment of money or security;
- The creditor is not involved in any other debt dispute with the debtor; and
- Service of the payment order on the debtor is possible.

However, if the debtor objects, the court has no jurisdiction to consider the merits of the objection (or the case) and the payment order shall be void immediately. Usually, creditors must therefore litigate or arbitrate prior to making an application to the court to enforce any judgment or award obtained.

With enforceable legal documents (eg, a court-issued payment order, a court judgment or arbitration award, or a debt document notarised by a

notary public as directly enforceable), creditors obtain repayment by application to the court on a first come, first served basis. Enforcement divisions established at various levels of the people's courts are responsible for compelling debtors to pay overdue debts, provided these are evidenced by enforceable legal documents. The law has clear provisions on the kinds of measures an enforcement division may use to ensure the enforcement of legally enforceable documents.

Successful enforcement is hard to achieve, due in part to local protectionism. PRC courts can be reluctant to enforce debts owed to foreign creditors, especially if this causes companies to close and employees to be laid off.

***(b) The enforcement of security***

A secured creditor must apply to court before any enforcement measures can be taken against the debtor's property. Secured creditors cannot legally enforce security without applying to court. As such, creditors often adopt a commercial approach and pursue a settlement rather than resorting to enforcement measures.

There is no concept of a floating charge, but certain security interests may be created and enforced over certain types of assets of the debtor. A security can be a guarantee, a mortgage, a pledge, a lien or even a deposit, as defined in the Security Law. In general, a mortgage can be given over land use rights, plant and equipment, and motor vehicles. To enforce a mortgage, the creditor must ensure that it has been duly registered with the relevant authorities (eg, the State Administration for Industry and Commerce, the Administration of Real Estate or the Administration of Motor Vehicles). Any mortgage document which provides that title to the mortgaged property will transfer to the creditor upon the debt falling due is void.

It is generally easiest to enforce a lien or deposit, as the property or money is already in the creditor's possession. It is more difficult for foreign creditors to enforce their security, as foreign debts and securities must be registered with and/or approved by the State Administration of Foreign Exchange.

When a debt falls due, the mortgagee or pledgee cannot take possession of the property mortgaged, unless the mortgagor or pledgor agrees to realise the security through auction or forced sale. Normally, the judgment specifies the amount of the outstanding debt, and the enforcement division recovers the judgment debt on behalf of the judgment creditor through forced sale or auction. As regards the enforcement procedure, there is no distinction between judgments obtained by secured creditors and those obtained by unsecured creditors. The enforcement division will compel the judgment debtor to satisfy the judgment sum. If the judgment debtor fails to do so, the enforcement division will dispose of any asset of the judgment debtor through auction or forced sale. If the asset to be realised is secured, the sale proceeds will be applied to settle the judgment debt and any surplus will be returned to the debtor or, if the debtor is bankrupt, distributed in accordance with the priorities set out in section 7. As the execution procedure is not transparent, the outcome is quite uncertain.

***(c) Corporate bankruptcy/liquidation processes***

PRC enterprises cannot voluntarily resolve to enter into bankruptcy. All bankruptcies must be declared by the court upon application by the debtor or a creditor, and in certain cases after the requisite approval has been obtained from the government/appropriate authorities.

Different legislation and regulations currently apply to different types of enterprise. The bankruptcy application must be made to the court where the debtor is incorporated or has its place of business. However, in view of the nature and implications of the bankruptcy proceedings, the court may decide to transfer the case to a higher court.

The applicable bankruptcy laws and regulations are as follows:

- The Enterprise Bankruptcy Law (for trial implementation 1986) (the 'Bankruptcy Law') applies only to state-owned enterprises (SOEs), together with the Rules on Several Issues about the Hearing of Enterprise Bankruptcy Cases, effective September 1 2002 ('the 2002 Rules').
- Non-SOEs - whether they be limited liability companies or companies limited by shares – are governed by the Civil Procedure Law, the Company Law, the Measures on the Liquidation of Foreign-Invested Enterprises, effective July 9 1996, and the 2002 Rules.
- The Opinions and Several Issues Relating to the Application of the Civil Procedure Law promulgated by the Supreme People's Court, and other opinions relating to the Bankruptcy Law, are also relevant to the bankruptcy of SOEs, foreign-invested enterprises (FIEs) and other non-SOEs.

While bankruptcy is available for enterprises in the People's Republic of China, it is not a procedure to which creditors often resort. Rumour also has it that the courts only hear a certain number of bankruptcy cases annually, as determined by the respective local governments. Accordingly, the procedure is not generally perceived as effective.

In addition, although not strictly in bankruptcy or liquidation, financial institutions can simply be 'closed' by the relevant authorities, such the People's Bank of China or the China Banking Regulatory Commission. The People's Bank of China has the authority to close down a financial institution if, for example:

- its losses reach 10 per cent of its capital;
- it fails its annual examination two years in a row; or
- it fails to improve after failing the examination.

Closure is announced without prior notice to creditors, and the relevant authorities make arrangements for the re-employment of employees and the disposal of assets. Little is known about how domestic creditors are dealt with. In the past, closure under the central banking regulations typically involved the repayment of foreign creditors in full. However, in the formal bankruptcy of Guangdong International Trust and Investment Corporation, which commenced in 1998 under the Bankruptcy Law, the creditors were not paid in full. Many valid debts were not even recognised by the liquidation committee, for a variety of reasons.

The draft law represents a more unified attempt to govern the bankruptcy of all types of enterprises, whether state or privately owned; but it has yet to be implemented.

### *(d) Formal corporate rescue processes*

**Current regime:** The Bankruptcy Law contains a restructuring procedure for SOEs, while the Civil Procedure Law applies to non-SOEs. The Civil Procedure Law provides that where a conciliatory or settlement agreement has been reached with the creditors and approved by the people's court, the people's court may terminate the bankruptcy. However, the law says nothing more about formal restructuring.

By comparison, the 2002 Rules provide a more detailed mechanism for formal restructuring, applicable to all legal persons. They stipulate that if, prior to a declaration of bankruptcy, a settlement agreement can be reached between the debtor and its creditors (two-thirds in value), and the court approves the settlement agreement, the bankruptcy proceedings will be stayed. If the settlement agreement is reached after a declaration of bankruptcy, the court will stay enforcement of the bankruptcy order. A court-approved settlement agreement is binding on all creditors.

If the debtor is an SOE and its creditors have initiated the bankruptcy proceedings, the higher-level department in charge of the SOE may apply for reorganisation within three months of the court accepting the case. If no higher-level department is in charge of the SOE, the shareholders (many existing SOEs have been converted into companies limited by shares, and newly established SOEs have shareholders) may pass a resolution (by at least two-thirds in value) to apply for reorganisation.

Once the application has been submitted, the debtor must draft a settlement agreement for submission to its creditors, stipulating the period within which it will repay its debts. The term of the restructuring cannot exceed two years. The relevant government authority is responsible for supervising the restructuring, and must report regularly on its progress to the court and the creditors' meeting. The restructuring begins once the settlement agreement has been approved by the creditors' meeting (by at least two-thirds in value) and recognised by the court.

The court will terminate a restructuring and declare the debtor bankrupt if:

- the reorganisation period has expired and the debts have not been repaid;
- certain activities (eg, breach of the settlement agreement) occur in the course of the restructuring;
- the debtor's financial situation continues to deteriorate; or
- the debtor participates in activities which seriously damage creditors' interests.

**Draft law:** Under the draft law, after the court has accepted a bankruptcy application but before the debtor is declared bankrupt, the debtor, its creditors or investors holding more than one-third of the registered capital may apply to the court for reorganisation. If the court permits the reorganisation to proceed, the debtor or the administrator must submit a draft reorganisation plan within six months (nine months if the court extends the deadline).

A creditors' meeting will be called within two months of submission of the draft reorganisation plan to the court, at which the different classes of creditors will vote on the plan. If the plan is

accepted by a majority in number and two-thirds in value of each class of creditors, the debtor or the administrator must apply to the court within 10 days for sanction of the plan. The court must issue its decision within 30 days.

Alternatively, the debtor may apply to the court for concilation after the bankruptcy application has been accepted but before a declaration of bankruptcy has been issued. If the court permits concilation, it will call a creditors' meeting to decide whether the draft conciliation plan should be accepted. The conciliation plan must be approved by the court if it is accepted by a majority in number present at the creditors' meeting and two-thirds in value of the total claims.

If the draft reorganisation or conciliation agreement is not accepted, the court will declare the debtor bankrupt.

#### (e) Informal corporate rescue processes

There are few reported or anecdotal cases of informal corporate rescues, other than those which are government sponsored. While a number of high-profile restructurings are ongoing, such as those of Guangdong Enterprises (Holdings) Ltd, Guangdong International Trust and Investment Corporation and Fujian Enterprises (Holdings) Ltd, all involve a Hong Kong, China – or otherwise foreign – creditor element. The explanation for this may lie in the way in which money has historically been lent to projects in the People's Republic of China. Typically, (foreign) bank creditors advanced funds to a Hong Kong, China 'window' company which on-lent to various PRC entities, often SOEs. The shares of the window company were usually owned by the SOE.

In such circumstances, the largest asset of the window company was its inter-company receivable from its PRC parent. Although many SOEs in the People's Republic of China are insolvent, their restructurings (where foreign creditors are involved) are typically carried out in accordance with Hong Kong, China rules. The principles applicable to informal corporate restructurings in Hong Kong, China generally apply, indirectly, to the restructuring of SOEs in the People's Republic of China. However, such application must be consensual.

Accordingly, informal restructurings in the People's Republic of China can take many forms. The nature of the restructuring is limited only by the collective imagination of the stakeholders and their financial and legal advisers, and depends heavily on the level of experience and financial wherewithal of the relevant municipal government. Municipal governments that are involved in a number of restructurings may be more open to different forms of restructuring. Their experience may mean that they are relatively easier for foreign creditors to deal with than a municipal government with no experience of restructuring. However, as restructuring practices deepen and broaden throughout the municipalities, those with little or no experience may be prepared to follow the example of more experienced ones.

The effectiveness of informal rescues cannot be denied. They are usually the only chance for foreign creditors to recover anything, given the uncertainties surrounding available legal remedies. However, it is still difficult to persuade PRC debtors to come to the negotiating table. Although legal remedies can be threatened, foreign creditors hoping for an out-of-court solution would be well advised to find ways to pressure the debtor to negotiate, even if this means making an application for the debtor's winding-up in the foreign jurisdiction. Cross-border tactics can be utilised only where certain pre-conditions exist.

### 1.2 What are the formal processes to effect a liquidation of the company's assets?

**Current regime:** In general, the liquidation or bankruptcy procedure for corporate entities is similar for SOEs, FIEs and wholly foreign-owned enterprises, although different legislation governs the procedures for each entity. The debtor or a creditor may apply to the court for bankruptcy.

Prior government approval is required before an SOE can apply for bankruptcy. Article 3 of the Bankruptcy Law provides that enterprises which are unable to repay due debts shall be declared bankrupt under the Bankruptcy Law. Article 8 of the Opinion of the Supreme People's Court on Several Issues in the Implementation of the Law of the People's Republic of China on Enterprise Bankruptcy provides that insolvency under Article 3 of the Bankruptcy Law indicates: "(1) the expiration of the repayment term of the debt; (2) that creditors have demanded repayment; and (3) clear evidence that the debtor is unable to pay its debts."

As the Bankruptcy Law requires that the bankruptcy application be made to the court where the debtor is located, regional differences arise in its application. If the

relevant court accepts the case, the SOE will likely be declared bankrupt. Acceptance depends on a number of variables and the court's discretion.

Under the Bankruptcy Law, the creditors' meeting (all creditors except secured creditors) has the power to:

- determine the existence and amount of the debts owed to each creditor;
- discuss and approve conciliation proposals (if any); and
- dispose of the debtor's assets and distribute the proceeds.

In practice, these responsibilities are performed by a liquidation committee or team. The Bankruptcy Law provides for *pari passu* distribution of the debtor's assets after the payment of certain creditors afforded priority under the Bankruptcy Law. However, detailed mechanisms for the sale and distribution of assets and adjudication of creditors' claims with respect to SOEs are absent from the legislation.

The bankruptcy of a non-SOE is governed by Chapter 19 of the Civil Procedure Law, the FIE Liquidation Measures and the 2002 Rules. Under these rules, bankruptcy proceedings may be initiated by the debtor or a creditor when the debtor fails to meet its liabilities as they fall due. The process is similar to the bankruptcy process for SOEs. A liquidation committee is formed after the debtor has been declared bankrupt, and is responsible for the custody, disposal and distribution of assets. The liquidation committee is subject to court supervision and must report its work to the court. Article 18 of the 2002 Rules provides that in order to expedite the bankruptcy proceedings and the establishment of a liquidation committee, the court, after accepting a bankruptcy case, may establish a supervisory committee if the debtor's management is unable to perform its duties and responsibilities properly. Members of the supervisory committee are selected from the higher-level department in charge of the enterprise or from representatives nominated at a shareholders' meeting. Professionals such as lawyers and accountants can also be members of the supervisory committee.

**Draft law:** Under the draft law, the debtor or a creditor can apply for bankruptcy on the grounds that the debtor is unable to pay its debts as they fall due and has insufficient assets to pay off all debts. There is no minimum amount of debt or requirement to make a prior demand; there is also no need for prior government approval. The court must decide whether to accept the bankruptcy application within 15 days of receipt. The court must notify the debtor within five days of acceptance of an application and appoint an administrator to take control of the debtor's property and business.

The administrator is responsible for the custody of assets, management of the business and investigation of the debtor's affairs. The administrator is answerable to the court and must report to and be supervised by the creditors, through creditors' meetings and the creditors' committee. The administrator must also prepare the list of creditors' claims for review at the first creditors' meeting. The court will confirm the list if there is no dispute, or alternatively will adjudicate any disputed claims. The administrator must then prepare a distribution plan for acceptance at a creditors' meeting, which must also be sanctioned by the court.

The concept of an administrator in the draft law is entirely new and welcomed.

### *1.3 What is the effect on debt collection and the enforcement of security of:*

#### *(a) An adjudication of corporate bankruptcy/liquidation?*

**Current regime:** Upon the court's acceptance of a bankruptcy application, all enforcement proceedings against the debtor's property are stayed. However, this does not apply to the enforcement of security, as security does not form part of the bankruptcy estate. If the proceeds from sale of the security exceed the outstanding debt owed to the secured creditor, the surplus will become part of the bankruptcy estate and will be distributed *pari passu* among the unsecured creditors once the claims of preferential creditors have been discharged.

Article 20 of the 2002 Rules provides that once the court has accepted a bankruptcy application, all other current civil enforcement procedures against the debtor's assets and all other current civil proceedings against the debtor shall be stayed. However, Article 19 provides that any first-instance civil proceedings where the debtor is named as the plaintiff will be transferred to the bankruptcy court.

**Draft law:** The draft law provides that any enforcement proceedings concerning the debtor's

property will be suspended after the court accepts the bankruptcy application. Pending court proceedings will be suspended after the court accepts the bankruptcy application, but will resume once the administrator assumes control of the debtor.

***(b) The commencement of a formal corporate rescue process?***

**Current regime:** Restructuring takes place only within bankruptcy proceedings and all enforcement proceedings against the debtor are stayed once the court has accepted the bankruptcy case. Secured creditors remain entitled to enforce their security, unless they have abandoned their right to do so under the settlement agreement.

**Draft law:** As reorganisation under the draft law commences after the court has accepted the bankruptcy application, all enforcement processes concerning the debtor's property will be suspended, but will be reinstated once an administrator is appointed. The right of secured creditors to enforce their security is also suspended unless the value of the security is at risk, in which case the secured creditor may apply to court to exercise this right.

***(c) The initiation of an informal corporate rescue process?***

There is usually an informal standstill on debt collection, but there is no binding freeze on creditor action, unless contractual. Formal standstills are rare. Informal standstills are usually relevant only to foreign creditors, which are more likely to abide by them as a matter of commercial convention. It is not known how domestic creditors are dealt with, as the government at local, municipal and state levels is not forthcoming with such information.

***(d) The initiation of an insolvency or insolvency-related process under any special legislation?***

There are no insolvency or insolvency-related processes under special legislation in the People's Republic of China.

### *1.4 Are insolvency procedures involving a corporation incorporated in your jurisdiction recognised if they are started in another jurisdiction?*

At present, there is no express recognition of foreign insolvencies in the PRC legislation. Courts generally refuse to recognise judgments of foreign creditors (other than some arbitration awards) on the basis that:

- recognition would be contrary to public policy; or
- the foreign jurisdiction does not reciprocate by recognising judgments of the PRC courts.

This is the case even between Hong Kong, China and the People's Republic of China. There are around 40 treaties between the People's Republic of China and foreign countries for the reciprocal enforcement of foreign judgments in a non-insolvency context. However, few are with major trading partners and almost none refer specifically to the recognition of bankruptcy proceedings. It is likely that only judgments would be recognised under these treaties, and not bankruptcy proceedings.

The proposed reforms on cross-border recognition are reflected in the draft law. It provides that, subject to the approval of the court, bankruptcy proceedings initiated outside the People's Republic of China may affect assets of the debtor located within the People's Republic of China. However, the proviso to the relevant article arguably renders its sentiment impotent. This states that foreign bankruptcy proceedings will not be recognised where:

- there is no treaty or practice of reciprocity governing the relationship between the People's Republic of China and the foreign jurisdiction;
- recognition of the foreign proceedings is not in the public interest; or
- recognition of the foreign proceedings would be detrimental to the legitimate interests of PRC creditors.

There is one known case in which a PRC court has 'recognised' a foreign bankruptcy – although the foreign liquidator did not ultimately pursue the recognition to obtain property owned by the debtor in the People's Republic of China. This was achieved through diplomatic channels, despite the fact that the foreign jurisdiction (Italy) and the People's Republic of China had signed a treaty on judicial assistance in 1992.

### *1.5 In what circumstances would the directors or officers of a company in financial difficulties face potential personal liability for continuing to trade? In practice, are any such provisions actually enforced?*

**Current regime:** No such rules currently exist. However, Article 103 of the 2002 Rules provides that the relevant authorities may prohibit persons responsible for the bankruptcy of a debtor from establishing new businesses or becoming directors, supervisors or managers of any enterprise within a prescribed timeframe – normally three years, as suggested by Article 57 of the Company Law.

**Draft law:** The draft law provides that directors, managers and key personnel of the debtor will be subject to personal liability where the bankruptcy resulted from breach of a duty of diligence and proper care. They will also be disqualified from acting as directors or holding a managerial position for a period of five years from the conclusion of the bankruptcy proceedings. Where misconduct constitutes a crime, they may be criminally prosecuted.

This is a new concept in the PRC bankruptcy regime and should be regarded as an attempt to embrace best practice standards of corporate governance.

## 2. What are the advantages and disadvantages of triggering a formal procedure?

One key advantage of a formal corporate rescue is that the parties may reach a compromise or conciliatory agreement. If agreement is reached, the court terminates the bankruptcy and the restructuring process begins.

Disadvantages include:

- the need to proceed under a formal bankruptcy;
- the limited (two-year) timeframe within which the restructuring must be completed; and
- the court's power, under certain circumstances, to terminate the restructuring and declare the debtor bankrupt before the end of the two-year period (see section 1.1(d)).

Administration of the restructuring plan will be carried out by the relevant government authority (for SOEs), which must report regularly to the creditors and the court.

Under the draft law, the administrator will be responsible for administration of the restructuring plan. The debtor will administer the plan only if it has applied to the court to do so, in which case the administrator will supervise the plan's implementation. As the two-year timeframe is not included in the draft law, it may be presumed that this requirement is no longer needed.

## 3. What are the practical options for out-of-court restructuring?

For detailed information on out-of-court restructurings, please refer to section 1.1(e).

As the need for restructuring grows and the number of companies likely to benefit begins to be realistically quantified, the forms of out-of-court restructuring will continue to evolve to meet specific needs, which may include sourcing capital, stabilising existing businesses and increasing the likelihood of future business development. The need for capital from financial and strategic investors, coupled with the desire to avoid unemployment or under-employment, should act as a catalyst for continued creativity in identifying various out-of-court restructuring options.

## 4. What is the effect on the management of a company of:

### *4.1 An adjudication of corporate bankruptcy/liquidation?*

**Current regime:** Upon the adjudication of bankruptcy, management loses its powers to deal with the debtor's assets, books, documents and materials. However, the debtor's registered legal representative (ie, the chairman of the board of directors in a limited liability company or the general manager of an SOE) is responsible for the safekeeping of the debtor's property before the liquidation committee takes over. The court may designate certain personnel to assist in the bankruptcy - often the debtor's legal representative, financial and accounting personnel, and property custodians.

In solvent liquidations of FIEs, management is prohibited from engaging in any new business activity and the liquidation committee is responsible for handling any unfinished business. The liquidation committee controls the solvent liquidation process.

**Draft law:** Under the draft law, the management will lose control of an insolvent debtor. Usually, the administrator (appointed shortly after the court accepts the bankruptcy application) will assume control of the debtor. The administrator

is answerable to the court, and must report to and be supervised by the creditors via creditors' meetings and the creditors' committee. The administrator may continue to manage the debtor's business pending the declaration of bankruptcy. Following the declaration of bankruptcy, the administrator's role is to realise and distribute the debtor's assets.

Members of the debtor's management cannot leave their place of domicile without the permission of the court, and cannot act as directors or manage other enterprises.

### *4.2 The commencement of a formal corporate rescue process?*

**Current regime:** In a formal corporate rescue, the government authority in charge of the debtor assumes control of the enterprise and reports regularly to the creditors. Management is not left in control as a debtor in possession.

**Draft law:** The draft law provides that the administrator in a reorganisation will assume control of the debtor and administer the reorganisation, unless management applies to court to continue to manage the debtor. In such case the debtor will submit the reorganisation plan to the court and the administrator will supervise the debtor during the reorganisation process.

### *4.3 The initiation of an informal corporate rescue process?*

Effectively, the municipal government of the province in which the debtor is located assumes control of the enterprise. Management remains involved at a cosmetic level, but no decisions are made without the approval of the local or provincial government, as it is usually the government that provides most of the funding for the restructuring. In some circumstances (ie, where there are issues involving exchange control regulations or debt registration), the state government (Beijing) must get involved, usually through the People's Bank of China.

### *4.4 The initiation of an insolvency or insolvency-related process under any special legislation?*

Not applicable.

## 5. Roles of key players involved in the restructuring and insolvency process

### *5.1 Who is responsible for the 'case management' control and administration of a corporate bankruptcy/ liquidation, a formal rescue or an informal rescue?*

**Corporate bankruptcy/liquidation:** The court-appointed liquidation committee assumes control of the debtor. The committee is responsible for the safekeeping, ordering, valuation, disposal and distribution of the debtor's assets, and may conduct necessary business activities accordingly. The committee is accountable to the court and the creditors, and must report regularly to the court.

The draft law provides that the administrator will take control of the enterprise and administer the bankruptcy. The administrator is answerable to the court and must report to and be supervised by the creditors, via creditors' meetings and the creditors' committee.

**Formal corporate rescue:** Under the Bankruptcy Law, the government authority in charge of the debtor takes control of it during the restructuring and must report regularly to the creditors' meeting.

Under the draft law, the administrator will propose a plan and take control of the debtor once the court has accepted the bankruptcy application. However, if the application for reorganisation and the reorganisation plan are submitted by the debtor, the administrator's role is to supervise the debtor in the reorganisation process. Once the plan has been approved by the creditors and sanctioned by the court, the administrator will hand over the administration to an executor, who is responsible for implementing the reorganisation plan. The administrator can be appointed as executor with the approval of the creditors and the court.

If the debtor applies for conciliation, the debtor is responsible for preparing the draft conciliation plan. If the creditors accept the proposal, the bankruptcy proceedings and the administrator's role are suspended and management regains control of the debtor.

**Informal corporate rescue:** The municipal government in which the debtor is located indirectly controls the process. Depending on the issues involved, the state government may also control certain aspects of the process. The level of government that should be consulted, and its

involvement, varies from workout to workout. This is one of the difficulties faced by foreign creditors in PRC restructurings. What is clear is that without the involvement of the relevant government, there would be no restructuring and the return to foreign creditors would be minimal.

### 5.2 Who is responsible for the 'case management' control and administration of a case of corporate insolvency under any special legislation?

Not applicable.

### 5.3 Who is responsible for preparing the restructuring plan in a formal or informal rescue?

**Formal corporate rescue:** The Supreme Court opinions (in respect of SOEs) divide the restructuring process into two categories:

- the restructuring or reorganisation of the debtor; and
- the compromise or rescheduling of its debts (often referred to as 'conciliation').

Under the Bankruptcy Law and Supreme Court opinions, the debtor must prepare a reorganisation plan providing for the repayment of its debts within a specified period, not exceeding two years. The reorganisation plan must be discussed with employee representatives in a meeting at which the circumstances of the reorganisation are reported; the meeting's opinion must be followed.

The reorganisation plan must include:

- an analysis of the reasons for the debtor's insolvency;
- a plan for a change in management;
- measures for improving the debtor's management and operation;
- the feasibility of measures for amending or changing production scopes;
- proposals for reducing losses and increasing profits; and
- the time limit and target of restructuring.

Under the draft law, after the court has accepted a bankruptcy application, the debtor, a creditor or any owner or stakeholder holding more than one-tenth of the capital of the debtor may apply for reorganisation. If the application is accepted, the administrator – with the debtor's assistance – will be responsible for preparing the reorganisation plan. Alternatively, the debtor may formulate and submit a draft plan to the court.

Where the debtor applies for conciliation, it is responsible for preparing the draft conciliation plan.

**Informal corporate rescue:** The restructuring plan is usually prepared by lawyers (typically in Hong Kong, China) acting for the steering committee of foreign creditors, in conjunction with the financial advisers (usually accountants or merchant bankers, or both) acting for the debtor/municipal government. While the debtor has a contractual relationship with its financial advisers, the municipal government commonly acts independently of the debtor's financial and legal advisers. Indirectly, the municipal government makes many decisions about the restructuring, as without it, few, if any, assets would be available to foreign creditors.

### 5.4 Who is responsible for preparing the restructuring plan in a case of corporate insolvency under any special legislation?

Not applicable.

## 6. What financial information is available to creditors in a corporate bankruptcy/liquidation, a formal rescue and an informal rescue?

Based on recent judicial developments, as well as the clarification of certain procedural aspects reflected in the 2002 Rules, there is no distinction or limitation on the type of financial information that should be made available to all parties during a liquidation or rescue. Directors and legal representatives must keep proper books and records, and deliver these to the relevant authorities pursuant to existing bankruptcy and procedural rules. The debtor and its staff must act in an appropriate manner to safeguard the debtor's assets. This responsibility includes the requirement to provide timely and accurate financial information to creditors.

## 7. Financial issues

### 7.1 What are the main areas from which funding is generally utilised by companies undertaking either formal or informal restructuring?

Due to the way in which restructuring occurs, little external funding is utilised. Extensive changes are necessary to make the Bankruptcy Law relevant to the current commercial environment in the People's Republic of China. The government, legal practitioners and academics are all aware of the

unfairness, inconsistencies and confusion created by the existing legislation, and the need for reform. Through the efforts of the Bankruptcy Law Drafting Committee, this is being addressed in various ways, including new proposed provisions reflected in the draft law.

While the draft law represents a step forward, further legislation must be passed before asset management companies can function as designed. Changes to the legal framework should provide stakeholders with a more practical roadmap for addressing insolvency issues.

Debt-for-equity swaps have been used during the restructuring process, and have helped debtors to reduce or eliminate current and future liability accruals; to a lesser extent, they have also relieved some cash-flow pressures. However, in most cases they have not necessarily improved operations, as this approach does not usually include participation in the debtor's management. Once legal protection is afforded to providers of new funding, stakeholders such as asset management companies will be able to seek out more effective long-term solutions, including actively promoting or seeking equity investments in insolvent companies.

### *7.2 In what order are creditors paid in a corporate bankruptcy/liquidation?*

**Current regime:** Article 37 of the Bankruptcy Law outlines the priorities regarding the distribution of assets among the creditors of a bankrupt SOE. The same priorities are set out in the 2002 Rules with respect to other legal entities.

After payment of the bankruptcy expenses, defined in Article 34 of the Bankruptcy Law and Article 88 of the 2002 Rules, liabilities must be discharged in the following order:

- outstanding wages and social security owed to employees;
- tax liabilities; and
- other liabilities, on a *pari passu* basis.

**Draft law:** Under the draft law, liabilities must be discharged in the following order:

- bankruptcy expenses, the administrator's fees and costs;
- debt incurred for the common benefit of the creditors, such as costs incurred by the administrator in continuing the debtor's business;
- outstanding wages (excluding those owed to directors, managers and other persons in charge of the debtor), social security insurance premiums and other overdue expenses owed to employees;
- outstanding tax liabilities; and
- ordinary bankruptcy claims.

Expenses incurred for the common benefit of creditors can be paid out of the debtor's assets at any time during the proceedings. If the debtor's assets are insufficient to pay any particular class of creditors in full, that class will be paid on a *pari passu* basis. Any unclaimed dividends payable to creditors and uncollected for two months after the announcement of the final distribution are to be deemed abandoned and distributed to other creditors.

As the draft law does not expressly state the position of secured creditors, the view is that secured claims should rank after outstanding wages, social security insurance premiums and overdue expenses owed to employees.

### *7.3 Are there any legal provisions that might operate to invalidate the creation of security, the disposal of an asset or the payment of a creditor by a company in financial difficulties?*

Payments made to certain creditors after the bankruptcy has been accepted – or, in the case of SOEs, in the six months prior to the date on which the bankruptcy is accepted up until the date of the bankruptcy declaration (the 'review period') – are null and void. Article 12 of the Bankruptcy Law allows for the payment of creditors if this is required for the normal production and operations of the debtor.

Impeachable transactions include:

- the concealment, private distribution or gratuitous transfer of assets;
- the transfer of assets at abnormally depressed prices;
- provision of security to originally unsecured creditors;
- repayment of debts before they become due; and
- the waiver of debts owed to the debtor.

The liquidation committee may apply to the court to recover property thus transferred.

Regarding antecedent and fraudulent transactions of an FIE, activities similar to impeachable transactions defined in the Bankruptcy Law which are conducted in the 180 days prior to the date on which liquidation

commences are void. Security provided by the FIE during the review period is also void.

Under the draft law, once the court has accepted a bankruptcy application, any payments made by the debtor to discharge a debt are invalid. The administrator has the power to review the debtor's affairs and investigate any questionable transactions. The administrator may apply to the court to have the following transactions declared void where they were conducted in the year prior to the court's acceptance of the bankruptcy application:

- the transfer of property for no value or at an undervalue;
- the provision of security for originally unsecured debts;
- the discharge of debts in advance of their due date; and
- the waiver of debts owed to the debtor.

The administrator can also apply to the court to rescind any payment made by the debtor within six months of the court's acceptance of the bankruptcy application if the administrator can show that the debtor had knowledge at the time of payment that, by making the payment, it would damage the other creditors' interests.

### *7.4 What is the position of both unsecured and secured creditors that vote against, do not agree with or do not consent to either a formal or an informal rescue plan?*

**Formal rescue plan:** Secured creditors are not entitled to vote at the creditors' meeting, as any secured property does not form part of the bankruptcy estate. Some commentators, such as the Honourable Judge Huang Chi Dong, the supervisor of the Supreme People's Court, and Professor Yang Yung Xin, professor of the University of Politics and Law, take the view that any corporate rescue plan approved by the unsecured creditors and sanctioned by the court is not binding on secured creditors. It follows that secured creditors have the right to enforce their security notwithstanding the corporate rescue plan. As regards unsecured creditors, where the corporate rescue plan is approved by a simple majority of the unsecured creditors attending the creditors' meeting, representing two-thirds in value of the total claims, and is subsequently sanctioned by the court, it will be binding on all unsecured creditors. There appears to be no appeal mechanism for any unsecured creditor aggrieved with the resolution and the court's sanction

Reorganisation under the draft law requires the approval of each class of creditors (secured, labour, taxation and ordinary) at a creditors' meeting. To be effective, the reorganisation plan must be approved by each class of creditors (by a majority in number of creditors present, representing at least two-thirds in value of the total claims in each class) and thereafter sanctioned by the court. If the reorganisation plan is not approved at the first meeting, the administrator may negotiate with the creditors and a second vote may be taken. If the plan is still not approved, the administrator may still apply to the court for approval and sanction if certain criteria are fulfilled.

In respect of a proposal by the debtor pursuant to the conciliation process under the draft law, a majority in number and two-thirds in value of all creditors must approve the plan, which must subsequently be sanctioned by the court.

Prior to sanctioning the plan, the court will consult the representatives of the debtor and investors, relevant governmental authorities and experts. Any creditors that do not agree with the plan can express their disagreement at this point.

Nevertheless, once the requisite creditor approval and court sanction have been obtained, the plan is binding on all creditors.

**Informal rescue:** This will depend on the terms of the rescue and whether the terms of the standstill agreement have been breached. In the absence of any formal standstill agreement, and assuming creditors have reserved their rights throughout the negotiation process, creditors are free to exercise their legal rights as best advised. This may result in the end of the restructuring process, so dissenting creditors must be placated in some way if the process is to continue.

### *7.5 What actions can creditors take if they are not satisfied with the conduct of either a formal rescue procedure or a corporate bankruptcy/liquidation?*

In a formal rescue, Article 32 of the 2002 Rules provides that dissatisfied creditors can apply for termination of the reorganisation and the commencement of bankruptcy proceedings. The grounds on which creditors can apply for termination are restricted to those listed in Article 21 of the Bankruptcy Law (ie, not implementing the settlement agreement, the debtor's worsening

financial condition and the commission of acts that are harmful to creditors).

Little can effectively be done where creditors are dissatisfied with the conduct of a corporate bankruptcy. There are no provisions for removal of the liquidation committee, challenging fees or other mechanisms common in bankruptcy legislation. Mechanisms that do exist involve appeals to the court charged with supervising the bankruptcy; but it is unlikely that this court will readily accept criticism of itself.

Under the draft law, if the executor of the reorganisation (ie, the administrator or the debtor) fails to act according to the approved plan, or if the debtor in a conciliation fails to abide by the approved plan, creditors may apply to the court to enforce the approved plan or have the debtor declared bankrupt.

## 8. General

### *8.1 Can the insolvency regime be described as systematic and efficient for:*

***(a) The liquidation of businesses incapable of being restructured?***

***(b) The restructuring of debt?***

The existing bankruptcy regime is far from systematic and efficient for the liquidation of enterprises or the restructuring of debt. The regime is in its infancy compared to those in other developed countries.

### *8.2 What are the biggest legal and non-legal impediments to the systematic and efficient liquidation of businesses and restructuring of debt?*

The biggest non-legal impediment is that the People's Republic of China still operates very much on a socialist economy basis. As a result, the primary focus of the bankruptcy regime is the resettlement of employees and reallocation of business/assets, to avoid any possibility of social unrest given the large number of failed SOEs. Creditors' interests are seldom the top priority in this environment.

As regards legal impediments, there are too many different laws, regulations, rules and supplementary notices which apply to the different types of enterprise. Many provisions in the various regulations are unclear, inconsistent and vague. Creditors also have limited rights and opportunities to participate in the bankruptcy process. Further, prior governmental approval is required for an enterprise to enter into bankruptcy, and authorities may not approve the bankruptcy application until there is a definite plan for resettling employees. The PRC legal system also lacks independence and transparency, while the judiciary has insufficient expertise in handling bankruptcy matters, both of which contribute to an inefficient bankruptcy regime. Even the implementation of the draft law, should this occur, is regarded by some as mere 'window dressing'.

### *8.3 Has the insolvency regime has been reformed in the last two years? If so:*

***(a) What are the reforms?***

***(b) Are the reforms being implemented so as to facilitate the systematic and efficient handling of corporate insolvency cases?***

No. However, the draft law passed the second of three readings before the Standing Committee of the National People's Congress in October 2004. Until the recent abandonment of the third reading, it was widely anticipated that the draft law would be implemented in 2005.

### *8.4 Are there any other legal or non-legal changes in the last two years that have impacted on the operation of the insolvency law regime?*

No.

### *8.5 Is statistical information on insolvency cases and corporate insolvency published? If so, how? Is it easily and freely accessible?*

At present, there is no publicly available statistical information on insolvency cases. However, the courts do compile statistical information for internal use.

### *8.6 What is the most urgent reform required to facilitate the systematic and efficient handling of corporate insolvency cases (formal and informal)?*

The most urgent reform is implementation of the draft law, which is a reasonably comprehensive bankruptcy law with provisions on formal restructuring and internationally recognised best practice standards for insolvency regimes. It will provide troubled companies with mechanisms to

undergo restructuring or to enter into liquidation, with an independent administrator in charge of the process. Although the draft law will not revamp the entire bankruptcy/legal system, it is a platform for the People's Republic of China to further develop an efficient bankruptcy regime and move towards a market economy.

Assuming the draft law is implemented in the future, the most urgent reform needed is a complete overhaul of the legal system, training of judges, and the separation of power from the judiciary and organs invested with political power.

The People's Republic of China also needs to accelerate its development of a social welfare and insurance system, and open up avenues for fund managers to invest funds collected through the system to alleviate concerns about unemployment and associated social unrest that bankruptcies may trigger.