

# Legal Issues: China, People's Republic

CMS Cameron McKenna

© CMS Cameron McKenna 2001

The People's Republic of China is a civil law jurisdiction. Creditors' rights are governed by the Bankruptcy Law and ancillary "legislation"/opinions (in the case of the state-owned enterprises), and the Civil Procedure Law (in the case of non-state owned enterprises), as well as disparate insolvency laws relating to foreign invested enterprises.

The People's Republic of China law recognizes the creation and enforcement of certain security interests over immovable/fixed assets. However, it has no concept of a floating charge. Creditors' rights are, in theory, enforced through a court system that is not considered mature or independent, and is marred by local protectionism (see Working Report of the Supreme People's Courts of China delivered on 10 March 1999).

While the bankruptcy and formal rescue of a state-owned enterprise or other financial institution is possible under existing legislation, there is only one known case of the liquidation of a large state-owned enterprise. There are no known cases of any formal corporate rescue proceedings under any relevant legislation. Accordingly, in the case of restructurings involving People's Republic of China assets, it has been common for them to proceed, informally, in accordance with the rules and structures that are applied in informal restructurings conducted in Hong Kong, China.

The main difficulties of restructuring in the People's Republic of China arise as a result of the following:

- ▲ The lack of experience in some provinces of government officials in restructuring.
- ▲ A lack of knowledge on the part of non-People's Republic of China creditors of the way in which proposals made by creditors for restructuring will be received by the relevant government officials and which government officials should receive them.
- ▲ A lack of understanding on the part of People's Republic of China debtors and non-People's Republic of China creditors of each other's legal systems, and what is expected of each party in the restructuring process.

Finally, if a restructuring involves leaving the People's Republic of China debtor in possession and a debt/equity swap with repayment being made in the form of dividends, non-People's Republic of China creditors may require substantial input in the management of the asset management company holding the shares of the insolvent People's Republic of China enterprise. However such an approach may not be welcomed or, in some cases, not permitted. Despite proposed reforms to the Bankruptcy Law, at present, creditors, who wish to insulate themselves from the uncertainties of the legal system and the lack of experience in restructurings, need to be extremely careful when investing in the People's Republic of China. If possible, creditors should secure their exposures in other countries due to the difficulty in obtaining access to and fair treatment in the People's Republic of China legal system.

## 1 Describe the nature and the effectiveness of the following processes:

### a) Civil unsecured debt collection remedies.

Creditors obtain repayment by application to the court on a first-come, first-served basis. Enforcement Divisions ("EDs") established under various levels of People's Courts, are responsible for compelling debtors to pay their overdue debts evidenced by enforceable legal documents.

In order to have the aid of an ED, a creditor must first obtain enforceable legal documents recognized by an ED. These include:

- ▲ A payment order issued by the court.
- ▲ A court judgment or arbitration award.
- ▲ A debt document notarized by a notary public as directly enforceable.

A creditor may ask a competent court for a payment order to be issued against the debtor, if three conditions are met:

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

With such a payment order, the competent ED will take all necessary steps to ensure that the order is complied with, i.e. repayment is made, by the debtor.

In most cases, creditors have to litigate or arbitrate before they can use the EDs to enforce their debts. The law has clear provisions as to the kinds of measures an ED may use to ensure enforcement of legally enforceable documents. However, it is widely admitted among People's Republic of China officials and the legal profession that successful enforcement has been very hard to achieve, due in part to local protectionism. It has been observed that courts of the same level in different municipalities or provinces produce dramatically different results. It has also been noted that People's Republic of China Courts at any level are reluctant to enforce debts owed to foreign creditors. Such courts will generally refuse to recognize judgments of foreign creditors on the basis that it would be contrary to People's Republic of China public policy or the foreign jurisdiction does not reciprocate by recognizing People's Republic of China judgments. However, there are two or three known cases where foreign creditors have succeeded under the People's Republic of China legal system.

**b) Secured property enforcement remedies.**

An application to the court needs to be made by the secured creditor before any enforcement measures can be taken against the debtor's property. Secured creditors cannot legally enforce security without applying to court.

**c) Any special debt collection or secured property remedies that are available to banking sector creditors.**

No special treatment is afforded to creditors in the banking sector.

**d) Corporate bankruptcy/liquidation processes that are available to corporate debtors and creditors.**

In 1986, the Bankruptcy Law (for a trial run) ("the Law") was set up to deal with cases where insolvent enterprises "owned by the whole people" (state-owned enterprises), were unable to pay their debts. The Law applies to state-owned enterprises such as the international trust and investment corporations, known as "itics". Guangdong itic, or "Gitic", is the most famous. Gitic is the first time that the Law had been applied to a state-owned enterprise that was a large financial institution. Prior to Gitic, the Law had been used for small state-owned enterprises only. Also prior to Gitic, financial institutions were simply "closed" by the relevant authorities, such as the People's Bank of China ("PBOC") under central banking regulations promulgated by the PBOC in 1994.

The PBOC has authority to close down a financial institution if, for example, losses reach 10 percent of capital or if the financial institution fails its annual examination two years in a row, or fails to improve after failing the examination, or any other circumstance deemed appropriate by the PBOC. Closure is announced without prior notice to creditors and the relevant government authorities make arrangements for the re-employment of the employees and the disposal of the assets. Little is known about how domestic creditors are handled. Closure under the central banking regulations typically involved full repayment of foreign creditors. However, in the formal bankruptcy of Gitic, its creditors will not be paid in full.

The debtor or any creditor may apply to the court for the bankruptcy of a state-owned enterprise. Where the debtor applies, the prior approval of the government is required (Article 8 of the Law). Article 3 of the Law provides that enterprises which are unable to repay debts that are due shall be declared bankrupt under the 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", attempts to clarify inability to pay debts. It provides that "insolvency" in article 3 of the 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....”

The Law provides that the application must be made to the People's Courts where the debtor is located. Hence, regional differences in the application of the Law arise.

The Law attempts to impose a regime for the adjudication of creditors' proofs and the getting in of assets and their distribution. The meeting of creditors (all creditors except secured creditors) is entrusted with the power to determine the existence or amount of debts owed to each creditor, discuss and approve proposals of reconciliation, or the disposal and distribution of the enterprise's assets. In practice, these responsibilities are performed by the liquidation "committee" or "team". The Law imposes *pari passu* distribution of the bankrupt enterprise's assets after payment of certain preferential creditors. However, detailed mechanisms for carrying out the sale and distribution of assets and adjudication of proofs of debt are absent in the People's Republic of China legislation.

The bankruptcy of a non-state-owned corporate enterprise is governed by the rules set out in Chapter 19 of the People's Republic of China Civil Procedure Law. Under these rules, a bankruptcy proceeding may be initiated either by the creditor or by the debtor, when the debtor fails to meet its liabilities when they become due. The process is similar to the liquidation process for state-owned enterprises, with a liquidation committee responsible for the custody, disposal and distribution of assets. The liquidation committee is subject to the supervision of the court and must report its work to it.

There is also in existence disparate legislation dealing with the liquidation of foreign invested enterprises ("FIEs") – (Measures on Liquidation of Foreign Invested Enterprises – issued, upon the approval of the State Council, by Ministry of Foreign Trade and Economic Cooperation ("MOFTEC") on 9th July 1996). The liquidation of solvent FIEs occurs at their termination and follows the bankruptcy rules under the Civil Procedure Law. Each FIE must go through the liquidation process at its termination. Where the FIE forms a liquidation committee by itself, the FIE goes into ordinary liquidation. However, in some cases the FIE cannot form a liquidation committee on its own, and the rules governing ordinary liquidation cannot be followed in those circumstances. The highest authority of the FIE (for example the board of directors, the shareholders or the creditors of the FIE) may apply to the FIE approval authority for special liquidation. Where special liquidation is applied for, the approval authority appoints the liquidation committee. The main rules of the liquidation are similar to those of a bankruptcy of a state-owned enterprise.

There is no provision in the liquidation process of an FIE that imposes a moratorium on debt enforcement, whether secured or unsecured. However, it is provided that the shareholders of an FIE are prohibited from disposing of the FIE's assets from the commencement of a liquidation. The liquidation starts from the date on which one of the following occurs:

- ▲ The operation or duration of the FIE expires.
- ▲ The approval authority approves dissolution of the FIE.
- ▲ The joint-venture contract of the FIE is terminated by court judgment or arbitration award.

The effect of liquidation on the management of a FIE is that it is prohibited from engaging in any new business activity. The liquidation committee is responsible for handling any unfinished business.

The liquidation committee, whether formed by the FIE in an ordinary liquidation or appointed by the approval authority in a special liquidation, controls the process of case management control and administration.

Regarding antecedent and fraudulent transactions of an FIE, activities, similar to impeachable transactions defined in the Law conducted by the FIE within 180 days prior to the date on which the liquidation starts the "review period", are void. Security provided by the FIE during the review period is also void.

e) Formal corporate rescue processes that are available to corporate debtors and creditors.

A restructuring procedure is provided as part of the bankruptcy law for state-owned enterprises. For non-state-owned enterprises, the Civil Procedure Law provides that where a "conciliatory" agreement has been reached with the creditors, the People's Court may, after approving the agreement, terminate the bankruptcy. Nothing more is said in the Civil Procedure Law about formal restructuring.

For state-owned enterprises, the government authority in charge of the bankrupt enterprise may apply to the court for the restructuring of the bankrupt enterprise within three months of the court accepting the case. The reaching of a conciliation or compromise agreement between the debtor enterprise and its creditors is a precondition for starting a restructuring. The term of restructuring cannot exceed two years. The government authority is responsible for the restructuring and is required to report regularly to the court on the progress.

The court will terminate a restructuring and declare bankruptcy of the enterprise if certain activities took place during the course of restructuring, such as breach of the conciliation agreement, the continual deterioration of the bankrupt's financial situation or activities that seriously damage the interests of creditors. There are no known cases of the procedure ever having been used in the People's Republic of China.

In the past, there were cases where a solvent state-owned enterprise was required, by administrative order, to merge with an insolvent one. This, in some cases, adversely affected the solvent state-owned enterprise. With the People's Republic of China state-owned enterprise reform, state-owned enterprises have started to sever their links with governmental authorities and have become more autonomous in making commercial decisions. The practice of merger as a result of governmental order is less and less used.

f) Informal corporate rescue processes.

There are no reported or anecdotal cases of informal corporate rescue initiated from within the People's Republic of China. While People's Republic of China assets are being used in a number of high profile restructurings, such as Guangdong Enterprises (Holdings) Ltd ("GDE"), Guangzhou itic ("Gzitic") and Fujian Enterprises (Holdings) Ltd ("FJE"), all involve a Hong Kong, China connection. The explanation for this may lie in the way in which money is lent to People's Republic of China projects. Typically, bank creditors (foreign) advance funds to a Hong Kong, China window company that on-lends to various People's Republic of China entities, usually state-owned enterprises. The shares of the window companies in Hong Kong, China are usually owned by the state-owned enterprise (the People's Republic of China parent of the Hong Kong, China window company).

In those circumstances, the Hong Kong, China window company's largest asset is often its inter-company debt to its People's Republic of China parent. Although many state-owned enterprises are insolvent in the People's Republic of China, their restructuring is carried out in accordance with Hong Kong, China "rules". The principles applicable to informal corporate restructurings in Hong Kong, China seem to apply, indirectly, to the restructuring of state-owned enterprises in the People's Republic of China.

Accordingly, People's Republic of China restructurings can take many different forms. The nature of the restructuring is limited only by the collective imagination of the legal and financial advisers involved and the level of experience of the relevant municipal government in restructurings. Municipal governments that are involved in a number of restructurings may be more open to different forms of restructurings. Their prior experience with restructurings may mean, for the foreign creditor, that they are relatively easier to deal with when compared to a municipal government with no experience in restructuring. However, as restructuring practices deepen and broaden throughout municipalities, it is expected that municipalities with little or no experience may be prepared to follow the example of other more experienced municipalities.

g) Any other corporate insolvency, or insolvency-related, processes that are available under special legislation.

There is no such special legislation applicable under these circumstances.

---

2 What is the effect upon debt enforcement and secured property enforcement processes of:

a) An adjudication of corporate bankruptcy/liquidation?

Upon a court's acceptance of a bankruptcy application, all enforcement proceedings upon the property of the bankrupt are stayed. The Law does not purport to have any extraterritorial effect. Academic opinion is divided on whether the moratorium on creditor action is extraterritorial. On balance, it is the author's view that there is no extraterritorial application of People's Republic of China bankruptcy law.

b) The commencement of a formal corporate rescue process?

All enforcement proceedings upon the relevant bankrupt remain stayed (formal corporate rescue process only commences after a court accepts the bankruptcy case).

c) The initiation of an informal corporate rescue process?

As in Hong Kong, China, there is usually an informal standstill of creditors. Formal standstill agreements are rare. The informal standstills are usually only relevant to non-People's Republic of China creditors ("foreign creditors"). It is not known how domestic People's Republic of China creditors are dealt with, as the People's Republic of China 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 is no such special legislation applicable under these circumstances.

---

3 What is the effect on the management of a corporation of:

a) An adjudication of corporate bankruptcy/liquidation?

The management of the bankrupt enterprise is deprived of the power to deal with the assets, books, documents, materials, etc. of the bankrupt enterprise. Property of the enterprise does not, however, vest in the liquidation committee. The liquidation committee is not necessarily made up of creditors. In practice, it is common that a large number of government officials who have little or no experience in liquidations are on the committee. In the case of Gitic, an experienced liquidator from a well-known international accounting firm works behind the scenes and assists the liquidation committee in performing their duties.

The registered "legal representative" of the bankrupt – the chairman of the board of directors in a limited liability company or the general manager of a state-owned enterprise – is required to be responsible for the safekeeping of the above-mentioned property before a liquidation committee takes over.

b) The commencement of a formal corporate rescue process?

The government authority in charge of the debtor takes over the debtor enterprise and reports regularly to the creditors. However, as already stated, there are no known instances of formal rescue in the People's Republic of China.

c) The initiation of an informal corporate rescue process?

Effectively, the municipal government of the province in which the insolvent enterprise is located takes over. The former management remains involved at a cosmetic level, but no decisions are made without the approval of the local or provincial government. For some issues, (i.e. that may involve exchange control regulations or debt registration), the state government (Beijing) must get involved, usually through the PBOC.

---

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

There is no such special legislation applicable under these circumstances.

---

4 Who is responsible for “case management” control and administration:

a) A corporate bankruptcy/liquidation?

The liquidation committee appointed by the court takes over the bankrupt enterprise and is responsible for the safekeeping, putting into order, valuation, disposal and distribution of the bankrupt's assets. The liquidation committee may conduct necessary business activities and is accountable to the court, reporting regularly to it.

b) A formal corporate rescue?

The government authority in charge of the enterprise takes control of the enterprise during the restructuring and reports regularly to the creditors' meeting.

c) An informal corporate rescue?

The municipal government where the enterprise is located indirectly controls the process. Depending on the issues involved, the state government will control certain aspects of the process. The level of involvement of the government and the level of government that should be consulted is not known and may vary from work out to work out. This is one of the difficulties faced by foreign creditors in People's Republic of China restructurings. What is clear is that without the involvement of the relevant governments, there would be no restructuring and the return to foreign creditors would be minimal.

d) A case of corporate insolvency under any special legislation?

There is no such special legislation in the People's Republic of China.

---

5 Who has the responsibility for the preparation of the plan of rescue under:

a) A formal corporate rescue?

The Law deals with restructuring by dividing it into two categories: the restructuring of the bankrupt and the compromise of its debts.

The government authority in charge of the bankrupt enterprise may apply to the court for the restructuring of the bankrupt enterprise.

In such a case, the enterprise prepares a restructuring proposal, which, after discussion at the employees' representatives' meeting, is submitted to the People's Court and the creditors' meeting. Under the Law, a restructuring proposal must include:

- ▲ An analysis of the reasons leading to the enterprise's insolvency.
- ▲ A plan of change of management.
- ▲ Measures for improving the management and operation of the enterprise, and the feasibility of measures of amending or changing production scopes.
- ▲ Proposals for reducing losses and increasing profits.
- ▲ The time limit and target of restructuring.

In the meantime, the enterprise prepares a draft conciliation or compromise agreement and submits it to the creditors' meeting. Under the Law, a conciliation or compromise agreement provides for (i) the sources of assets proposed to be used to repay debts, (ii) the means and time of repayment and (iii) the extent of any haircut, if applicable. After an agreement is reached between the debtor enterprise and the creditors, the conciliation or compromise agreement needs to be submitted to the People's Court for confirmation. The agreement becomes effective only when confirmation is given and publication is made by the People's Court.

The conclusion of a conciliation or compromise agreement, is a precondition of the formal restructuring of the enterprise.

In practice, there is no evidence that the procedure has been used.

---

**b) An informal corporate rescue?**

Responsibility for the plan usually resides with the lawyers (typically in Hong Kong, China) acting for the steering committee of the 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 the contractual relationship with its financial advisers, it is common for the relevant municipal government to act independently of the debtor's financial and legal advisers. Indirectly, the municipal government makes many of the decisions about the restructuring, as without it, there would be few, if any, assets available to foreign creditors.

**c) A case of corporate insolvency under any special legislation?**

There is no such special legislation in the People's Republic of China.

---

**6 How are the different classes of creditors treated in relation to:**

**a) A formal corporate rescue?**

A precondition for the start of a corporate restructuring is the conclusion of a conciliation agreement between the debtor and the creditors. Such agreement needs to be approved by a majority of creditors in number representing more than two thirds in value of the unsecured debts. Secured creditors are not allowed to vote at the meeting of creditors, as only unsecured creditors are entitled to vote.

The resolution of the meeting of creditors is binding on all creditors, including secured creditors. The legislation does not specify how different classes of creditors should be treated. However, in a formal bankruptcy, it is clear from a State Council directive of 25 October 1994 – "Proposal for Carrying out State-Enterprise Bankruptcy Law in Some Cities (Document 59)" that where this directive applies the first priority is to re-settle employees. Article 4 of the Law provides that the State shall arrange for appropriate re-employment of staff and workers of bankrupt enterprises and shall guarantee the basic living needs prior to re-employment. The specific measures are separately stipulated by the State Council in Document 59. In summary, they involve the resettlement of the employees in order to maintain order and stability in the society, the priority payment of employees' resettlement claims and wages, etc. Such things as staff quarters, schools, nurseries and hospitals and other welfare facilities of the bankrupt enterprise do not form part of the bankruptcy property available for distribution and are confiscated by the government of the province or region. Further, there is provision for the government of the province or region to take appropriate measures to re-train employees, refer employees to other enterprises or export the employees' skills with a view to resettling the employees and insuring them of a basic living before they find a new job.

As already stated, there are no known instances of formal corporate rescue in the People's Republic of China. However, in view of the emphasis placed upon the handling of employees in the formal bankruptcy of a state-owned enterprise, it is assumed that a similar emphasis would be placed upon a formal corporate rescue under the Law. However, there is nothing in the legislation for formal corporate rescue, according any particular treatment of different classes of creditors.

**b) An informal corporate rescue?**

The starting point, in theory, is to treat creditors in the same way as they would be treated under the liquidation laws of Hong Kong, China. However, it is common for all creditors, other than secured creditors, to be treated identically, irrespective of class. It is common for the municipal government to supply the assets/funds to support the restructuring. Usually, the municipal government will make only one pool of assets available against which all creditors "prove". It is common for creditors holding guarantees to be treated no differently to those that have no guarantees.

The treatment of employees in an informal restructuring depends on the municipal government's plan for the region. Not a lot is known about how any level of the government in the People's Republic of China deals with domestic employees. It is surmised that the government provides for the "the well-being of employees by ensuring, for example, that they are adequately housed and fed."

**c) A case of corporate insolvency under any special legislation?**

See comments (above) regarding Document 59 in the case of bankruptcy of a state-owned enterprise under the Law.

---

**7 What is the position of both unsecured and secured creditors who vote against, do not agree with, or do not consent to, a plan of rescue in relation to:**

**a) A formal corporate rescue?**

If a creditor considers the resolution contrary to the provisions of law, opposing creditors (including unsecured and secured creditors) may apply for a ruling to the People's Court that accepted the case within seven days of a resolution being made at a creditors' meeting. Such ruling of the court is final. It seems that it is still open for creditors to take action in other jurisdictions where assets are located, subject to the intervention of the liquidation committee in those jurisdictions.

**b) An informal corporate rescue?**

This will depend on the terms of rescue and whether there is a standstill agreement whose terms have been breached. In the absence of any formal standstill agreement (which is common) and assuming creditors have reserved their rights throughout the negotiation process, creditors will be free to exercise their legal rights as best advised. This, of course, may result in the end of the restructuring process, so dissenting creditors have to be placated in some way if the process is to continue.

**c) A case of corporate insolvency under any special legislation?**

There is no such special legislation applicable under these circumstances.

---

**8 In relation to the need for an insolvent corporation to have urgent working capital funding, what difficulties are encountered in the provision of such funding in relation to:**

**a) A formal corporate rescue?**

The relevant law does not touch on such issues directly. There are no known cases of formal rescue in the People's Republic of China. It is suspected that the government would support working capital requirements as it has done in the case of informal corporate rescues.

**b) An informal corporate rescue?**

Generally, the enterprise will effectively cease operations or the provincial government will support the debtor's business operations – usually on a scaled-down basis – until the rescue is implemented. Where new money is required, it is open to the enterprise to request the banks to advance funds with appropriate security and assurances. In practice, this is rare, as security in the People's Republic of China is difficult to enforce and guarantees from the government are no longer given. It has been observed that foreign creditors now treat arrangements such as guarantees or letters of comfort from municipal governments with skepticism, as they have not always been honored in the past.

**c) A case of corporate insolvency under any special legislation?**

There is no such special legislation applicable under these circumstances.

---

9 Briefly describe the relevant provisions relating to the setting aside of antecedent and fraudulent transactions in relation to:

a) A corporate bankruptcy/liquidation.

The transactions conducted by an insolvent enterprise during the period starting from six months prior to the date on which the court accepted the bankruptcy case and ending on the date on which a bankruptcy declaration was made by the court (the review period) are subject to court review. Impeachable transactions include:

- ▲ Concealing, private distribution or gratuitous transfers of assets.
- ▲ Transfers of assets at unreasonable prices.
- ▲ Provision of security to originally unsecured creditors.
- ▲ Repayment of debts before they become due.
- ▲ The waiver of debts owed to the insolvent enterprise.

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

b) A formal corporate rescue.

Under the relevant People's Republic of China law, restructuring occurs only after the court has taken the bankruptcy case and, in the case of an unsuccessful restructuring, before the declaration of bankruptcy. Therefore, the above provisions appear to apply, as in a formal bankruptcy, only where the restructuring fails.

c) A case of corporate insolvency under any special legislation.

There is no such special legislation applicable under these circumstances.

---

10 Are there any provisions of law that might operate to invalidate a secured property transaction in relation to:

a) A corporate bankruptcy/liquidation?

As mentioned above, security given during the review period will be invalidated if it was given to secure a previously unsecured debt.

b) A formal corporate rescue?

Please refer to Section 9 above.

c) A case of corporate insolvency under any special legislation?

There is no such special legislation applicable under these circumstances.

---

11 Describe the difficulties that are encountered in endeavoring to administer cases of corporate bankruptcy/liquidation and formal corporate rescue that involve property and business interests located in more than one jurisdiction.

The closed legal system in the People's Republic of China makes it difficult for foreign creditors to comprehend the laws and processes that govern corporate bankruptcy or rescue. The lack of restructuring experience according to open market principles increases the burden for foreign creditors. The practice of dealing with the financial difficulties of state-owned enterprises "in house" adds to the difficulties.

Many of the state-owned enterprises have assets located all over the world, particularly in Hong Kong, China. However, the People's Republic of China has yet to apply for recognition or ancillary liquidation of Gitic in any jurisdiction other than the People's Republic of China. Accordingly, it is open to creditors to take such action as they are advised in other jurisdictions. The Gitic bankruptcy is, to date, confined to the People's Republic of China in its administration, despite the wide-ranging location of assets and business interests in other jurisdictions.

It remains to be seen how the Gitic bankruptcy will evolve and whether Gitic will be placed under any formal insolvency regime in other jurisdictions and if so, what effect this will have on the People's Republic of China administration of the bankruptcy. These questions are yet to be answered.

---

**Additional comments on the "debt-to-equity-swap policy"**

The policy of debt-to-equity-swap adopted in the People's Republic of China reform of its financially deeply-troubled state-owned enterprises has been widely viewed as a means of achieving a win-win result for both the state-owned enterprise debtors and bank creditors.

Under the policy, debts owed to banks are swapped for a shareholding in the debtor, which is held by an asset management company owned by the banks. The theory is that interest payments are reduced (if not waived), management is improved, and creditors have a new chance to recover their debt by way of receiving dividends from the asset management company. Usually, there is a mix of debt/equity swap and payment of a certain amount directly to bank creditors in return for a release of debt. In some cases, creditors are given an alternative to swap debt for equity or they can take a "cash out" option, instead.

Currently, the policy applies only to large- or medium-sized state-owned enterprises and state-owned commercial banks. The State Economic and Trade Commission ("SETC") is responsible for recommending state-owned enterprises to enter into these types of arrangements. Debt-to-equity-swap agreements are negotiated and concluded between state-owned enterprises and asset management companies representing the banks. Such agreements are required to be approved by SETC, before they can be implemented.

By the end of 1999, the SETC recommended 601 state-owned enterprises for this type of restructuring, which involved debts valuing RMB495.6 billion. By the end of July 2000, 485 state-owned enterprises had negotiated debt-to-equity swap agreements with asset management companies and 62 of these agreements were approved by the SETC.

There have been reports that some state-owned enterprises will make profits this year, as a direct result of the implementation of the debt-to-equity-swap.

It has yet to be explored as to whether and how this policy will apply to cases in which creditors are foreigners.

## CMS Cameron McKenna

**Contacts:** David Kidd, Head, Corporate Recovery and Restructuring, and Prudence Mitchell, Partner, Corporate Recovery and Restructuring, Hong Kong, China

Aili Zhao, Consultant, and Youngfu Li, Chief Representative and Resident Partner, Beijing

7th Floor, Hutchinson House  
10 Harcourt Road  
Central,  
Hong Kong, China

**Phone:** +852 2846 9101/142

**Fax:** +852 2845 3575

**E-mail:** prudence.mitchell@cmck.com  
david.kidd@cmck.com

Room 1503, Landmark Tower 1  
8 North Dongsanhuan Road  
Chaoyang District, Beijing 100004  
People's Republic of China

**Phone:** +86 10 6590 0389

**Fax:** +86 10 6590 0102

**E-mail:** youngfu.li@cmck.com  
aili.zhao@cmck.com

# Financial issues: China, People's Republic

PricewaterhouseCoopers

© PricewaterhouseCoopers 2001

1 Is the insolvency legislation generally:

- a) Understood?
- b) Being followed and/or available opportunities being taken up?
- c) Being enforced by relevant authorities?

Insolvency was not a known legal concept in the People's Republic of China planned economy until 1986 when the People's Congress passed the first Bankruptcy Law (the "Old Law"). The economy at the time was comprised entirely of state-owned enterprises and the legislation reflects this. In more recent years, market economy concepts have been introduced, yet due to the continued existence of strong government controls, the economic and legal systems have been slow to adjust to take full advantage of these ideas.

The Old Law addresses all basic aspects related to bankruptcy and sets clear guidance on its handling, such as the application process, obligation of the creditors' committee, restructuring and liquidation.

During the on-going transformation process, called "economic reform", the existing insolvency legislation proved to be insufficient in respect to the growing number of privately-owned businesses arising under the market economy. Proportionally, loans to privately-owned businesses are still extremely limited when compared with lending volume to state-owned enterprises.

In 1991 the People's Congress passed a bankruptcy guide for privately-owned enterprises as part of the civil legislation. This guide is extremely simple and short in length.

In 1994, the first set of Corporate Law was enacted. Although the chronological order of the series of commercial laws is somewhat awkward, the significance of the Corporate Law cannot be under-estimated. Prior to the enactment of the Corporate Law, all state-owned entities were given the status of "enterprise". Since the State is the sole owner, the legal and ownership structure for enterprises do not provide a foundation for more complicated commercial transactions, such as change of ownership. The new Corporate Law introduced the concept of shareholders and legalized the rights of a shareholder for the first time. This Corporate Law laid down the fundamental basis upon which other commercial legislation, such as the insolvency or restructuring law, can be built.

The current legislation simply provides a set of legalized procedures to terminate certain state-owned enterprises and relieve the government of its burdens. Therefore, it is badly in need of updating since the Corporate Law has taken effect. As such, the legislation is understood, being followed and being enforced. However, this is clearly not effective, as the legislation being followed is inadequate.

2 Broadly speaking, in practice, does the insolvency/restructuring legislation tend to lead to:

- a) Early recognition and action?
- b) Restructuring alternatives and action?

Under the Old Law, profitability was not the sole factor considered by the State when determining which entities to close. Likewise, creditors' rights were not a top priority. Typically, these organizations have been unprofitable and operating under government subsidy for many years prior to their bankruptcy proceedings.

Because of social stability factors, all bankruptcies are carefully selected by the central government, hence the limited number of bankruptcy cases per year. Conversely, given the importance of social stability, both components of the Bankruptcy Law failed to provide guidance on the disposition of the employees. As a result, the current legislation was simply not designed to protect creditors and offer restructuring opportunities to debtors. The legislation is therefore ineffective in meeting the above objectives.

3 What are the main practical difficulties being encountered in:

- a) The preparation of restructuring plans?
- b) The implementation of restructuring plans?

Burdened by the heavy load of non-performing loans resulted from government policy lending in the past, the four largest state-owned banks have struggled to regain strong financial performance and growth. Further more, the problem assets often become roadblocks in the commercialization for People's Republic of China banks. To demonstrate its determination to build a sound financial system and ease the burden of the state banks, the People's Republic of China government established four

asset management companies ("AMC") in 1999. The AMCs were created to handle the problem assets transferred from the four state banks. To date, the estimated total of problem assets transferred to the AMCs is US\$1.2 trillion, with the majority of these assets belonging to state-owned enterprises.

Although the four asset management companies are assigned with the task of resolving bad debts, they are constrained by the current non-commercial insolvency legislation, government approvals of most commercial decisions, and an economy that is not large enough or healthy enough to absorb these problem assets.

All restructuring plans are standardized. Because they are currently directed by the government and welcomed by most borrowers, all deals can be closed without much effort. However, execution of additional agreement terms, such as the debt repurchase at the end of the equity term, remain untested and the effectiveness and feasibility of these terms remain unknown.

The ability to create effective restructuring plans is particularly hampered by the significant further problem that even though the AMC has become the controlling shareholder, it is not able to participate in the management of the company. This creates further problems in finding proper commercial solutions to the corporation's problems.

Furthermore, the existing legislation does not grant the creditors or the converted shareholders with appropriate rights, even though the creditors have taken all related risks. This is a further hindrance to effective restructuring plans.

As a whole, the deeply troubled state sector is facing restructuring on all levels. But figuring out how to restructure the massive and problematic state sector for the world's most populous developing country is not an easy task.

---

4 To what extent are companies that are going through any formal or informal restructuring merely adjusting their debt/equity structure, rather than genuinely restructuring their business operations?

Debt-to-equity swaps have helped the borrowers only in reducing or eliminating the current and future interest liabilities accrued. This relieves the company of some cash flow pressure, but does not necessarily improve their operations. The debt-to-equity swaps, therefore, are merely changes in the structure of the debt rather than a true restructuring of the business operations of the borrowers.

---

5 What are the main areas from which funding is generally being utilized by companies which undertake either formal or informal restructuring?

Due to the way in which restructuring occurs, there is little external funding applied to these restructures. Clearly, a wide-range of changes is necessary to make the Bankruptcy Law relevant to the current commercial environment in the People's Republic of China. The government is aware of the unfairness in the existing legislation and the need for an update. New legislation will have to be passed before AMCs can function as they were designed. Insolvency and restructuring are still in their infancy in the People's Republic of China and there will be changes to both the legal framework and practical implementation of insolvency.

The most important next step for the AMCs appears to be further participation in borrowers' management. Once legal protections are provided through new legislation, the AMCs will be able to seek out more effective long-term solutions, including seeking other equity investments in insolvent companies.

## PricewaterhouseCoopers

**Contact:** Ting Liu, Senior Manager

Beijing Kerry Centre, 18th Floor  
1 Guang Hua Road  
Chao Yang District  
Beijing 100020  
People's Republic of China

**Phone:** +86 10 6561 2233  
**Fax:** +86 10 8529 9000  
**E-mail:** Ting.Liu@cn.pwcglobal.com