

Global Restructuring & Insolvency Guide

China

Overview and Introduction

On 27 August 2006, the Standing Committee of the 10th National People's Congress of the People's Republic of China ("PRC") promulgated the new *Law of the People's Republic of China on Enterprise Bankruptcy* ("**Bankruptcy Law**"), which came into force on 1 June 2007.

The new bankruptcy regime is a major milestone for China. For the first time in its history, China has a unified and comprehensive bankruptcy system covering all types of enterprises, including foreign investment vehicles and state-owned enterprises.

Similar to many jurisdictions, the new bankruptcy regime introduced key concepts such as:

- voluntary and involuntary bankruptcy;
- an independent administrator;
- involvement of creditors in the administration of the bankruptcy;
- restructuring and settlement;
- extraterritoriality, allowing property outside China and certain foreign proceedings to fall within the regime;
- voidable transactions; and
- ratable distribution.

A significant feature of the new legislation relates to the protection of workers' rights. The new regime ranks employees ahead of other unsecured creditors but behind secured creditors, who retain their priority over secured assets.

Applicable Legislation

The Bankruptcy Law, which consists of 136 articles organized into 12 chapters, applies to all types of insolvent enterprises, whether state-owned or privately owned, and includes foreign investment enterprises and financial institutions. It does not apply to individual natural persons.

The new legislation only applies to PRC entities, although it extends beyond China's borders in relation to a debtor's overseas properties. The new regime also recognises certain foreign proceedings that seek to secure assets located in China.

Personal Bankruptcy

There has been no law passed governing individual bankruptcy in China.

Corporate Restructuring and Insolvency

Court-Based Insolvencies

Grounds for Bankruptcy

The new regime introduces an insolvency test as a ground for bankruptcy. An enterprise will qualify for bankruptcy, restructuring or settlement under the Bankruptcy Law if the enterprise is not able to

meet its obligations to repay its debts and its assets are less than its liabilities or it is obviously incapable of paying off its debts.

Application to Court

Bankruptcy proceedings are commenced in the People's Court where the enterprise is domiciled and can be initiated by either the debtor or its creditors. If the debtor is a financial institution, the court application shall be filed by the relevant regulatory authorities under the State Council.

Appointment of an Administrator

Upon acceptance of the bankruptcy application, the court appoints a bankruptcy administrator who may be a member of recognised legal, accounting or specialist bankruptcy firms, or possess relevant professional expertise and qualifications. The mode of selecting an administrator and his remuneration is determined by the Supreme People's Court.

The administrator reports to the People's Court and is supervised by the creditors' meeting and the creditors' committee. The creditors' meeting has the ability to replace the administrator or to seek his removal should he fail in performing his duties in a lawful and impartial manner, or if the creditors' meeting deems there are circumstances that prevent him from performing his duties competently.

The administrator's powers and duties include:

- taking control of the debtor's property, company seals, accounting records, documents and other related materials;
- investigating and reporting on the debtor's financial status;
- making decisions in relation to the debtor's internal management and daily expenditure;
- deciding whether to continue or suspend the debtor's business operations prior to the first creditors' meeting;
- managing and disposing of the debtor's property;
- representing the debtor in litigation, arbitration or other proceedings;
- proposing the holding of creditors' meetings; and
- performing other functions that may be required by the court.

An administrator who fails to act with due diligence and care and to faithfully perform his duties could face a fine or personal liability if found to have caused loss to a creditor, the debtor or a third party.

Creditors' Claims

Creditors are required to file their claims within a time period stipulated by the People's Court. Such period commences from the date of publication by the People's Court of the announcement of its acceptance of the bankruptcy petition and runs for a minimum of 30 days and a maximum of three months.

Major eligible claims include:

- debts that exist at the time of the court's acceptance of the application for bankruptcy;
- unmatured debts;
- conditional debts or debts subject to time limits;
- claims pending litigation or arbitration;

- debts owed to joint creditors;
- indemnity obligations owed to a guarantor of the debtor or to another joint debtor who has discharged a debt on behalf of the debtor; and
- damages under a contract terminated by the administrator or the debtor under the provisions of the Bankruptcy Law.

Creditors' Meetings

Creditors may participate in the bankruptcy process through creditors' meetings and the creditors' committee.

A creditor who has submitted a claim in the bankruptcy is entitled to attend and vote at the creditors' meeting (save for secured creditors who cannot vote on the adoption of a settlement plan or distribution plan of the debtor's assets unless they have waived their right to priority). However, a creditor whose claim has not been determined may not exercise voting rights except where the People's Court has provisionally determined the amount of the claim for the purpose of allowing the creditor to vote. Generally, a resolution of the creditors' meeting is passed by a simple majority of the creditors with voting rights present at the meeting and a majority representing 50% or more of the value of the debtor's unsecured debt.

The creditors' meeting may:

- verify creditors' claims;
- apply with the court to replace or remove the administrator;
- supervise the administrator;
- select members of the creditors' committee;
- determine whether to continue or suspend the debtor's business operations;
- approve restructuring plans and settlement agreements;
- approve plans to manage, realize and distribute the debtor's property; or
- perform other functions that the court requires.

Creditors' Committee

The creditors' meeting may establish a creditors' committee that comprises creditor representatives elected by the creditors' meeting. The composition of the creditors' committee, which totals not more than nine people and must include a representative of the debtor's employees or a representative of its trade union, is subject to the approval of the People's Court in writing. The creditors' committee is responsible for supervising the management, disposal and distribution of the debtor's property, proposing the convening of creditors' meetings and such other duties as may be delegated by the creditors' meeting.

Creditors' Right to Set-Off

Creditors who incurred debts to the debtor prior to the court's acceptance of the bankruptcy application may request the administrator to set off their debts against their claims. However, set-off is not permitted if the creditor incurred the debt with knowledge of the debtor's inability to repay its debts unless the debt was incurred more than one year prior to the application for bankruptcy or is due by operation of law.

Counterparties to Contracts

Contracts entered into before the acceptance of the bankruptcy application but not yet fully performed can be terminated or continued by the administrator. The administrator is required to notify the counterparty of his decision within two months of the acceptance of the bankruptcy application or 30 days after receiving a reminder from the counterparty. Failure to do so deems the contract to be terminated. If the administrator decides to continue a contract, the counterparty is entitled to request the administrator to provide a guarantee. A failure to provide the guarantee also deems the contract to be terminated. If a contract is terminated in accordance with the legislation, the counterparty may file its claim on the basis of its right to claim damages as a result of the termination.

Priority and Ranking of Debts

The Bankruptcy Law sets out a hierarchy of debts to determine priority of payment, which must be made in the following order:

- bankruptcy expenses;
- common interest debts (i.e. certain debts incurred after the court accepts the bankruptcy petition);
- employee claims, including unpaid salaries, medical and disability subsidies, basic old-age and medical insurance premiums, and compensation in accordance with PRC law;
- social insurance premiums and outstanding tax; and
- common (unsecured) claims in bankruptcy.

If the property in bankruptcy is insufficient to satisfy the discharge requirements of a certain rank of debts, the distribution to such rank shall be effected on a *pro rata* basis.

Secured creditors generally have priority to the extent of the value of their secured properties while any shortfall is to be treated as an unsecured claim. However, employee claims accrued prior to the promulgation of the Bankruptcy Law on 27 August 2006 will continue to enjoy their right (under the previous law) to priority over secured creditors.

Restructuring and Settlement

An important feature of the new regime is the availability of rescue options within the formal process to restructure or rehabilitate viable businesses. Although the court may have accepted a bankruptcy application, the Bankruptcy Law allows a debtor or its creditors the opportunity prior to an enterprise being declared bankrupt to apply with the court for restructuring or reorganisation of its business. The legislation also allows a debtor to apply for a compromise or settlement of its debts with its creditors.

Restructuring Procedure

Prior to the enterprise being declared bankrupt, the debtor or its creditors can apply to the People's Court for restructuring. The debtor or administrator must submit a draft restructuring plan to the court and the creditors' meeting within six months (with an extension of three months if approved by the court) of the court's ruling for restructuring. During the restructuring period, the debtor can apply for court approval to continue to manage its properties and business under the administrator's supervision.

Creditors are classified into the following voting groups:

- creditors with secured claims over specific properties of the debtor;
- employees with claims on salaries, medical and disability subsidies, basic old-age and medical insurance premiums, and compensation payable into the individual accounts of employees in accordance with PRC law;
- claims on outstanding taxes, and

- common (unsecured) claims.

Upon receipt of the draft restructuring plan, the court convenes a creditors' meeting within 30 days to vote on the draft plan. The draft plan must be approved by a majority of the number of creditors in each voting group, and the amount of claims they represent must account for at least two-thirds of the total amount of claims in that group. If the draft restructuring plan is not approved by all of the voting groups, the debtor or the administrator can still apply to the court for approval if certain conditions are satisfied. If the restructuring plan is not approved, the court terminates the restructuring and declares the debtor bankrupt.

The debtor is responsible for the implementation of the restructuring plan. A supervision period is imposed by the court, during which time the administrator is required to supervise the implementation process and the debtor must report to the administrator. If the debtor is unable or fails to implement the restructuring plan, the court terminates the restructuring plan and declares the debtor bankrupt upon petition from the administrator or a materially interested party.

During the restructuring period, the court has additional powers to terminate the restructuring plan and declare the debtor bankrupt if:

- the debtor's business operation or financial status continues to deteriorate and cannot be salvaged;
- the debtor has acted fraudulently, diminishes its assets in bad faith or has acted in a way that is adverse to the creditors; or
- the administrator is unable to perform his duties and functions as a result of the debtor's actions.

Secured creditors' rights over pledged assets are suspended during the restructuring period. If there is a risk of damage to the secured asset or of significant diminution in its value such that the secured creditors' rights are prejudiced, the secured creditor may apply with the People's Court to enforce its rights. Once the restructuring plan is approved by the court, it is binding on the debtor and all of the creditors.

Settlement Procedure

Settlement allows the debtor to compromise its debts directly with its creditors after the bankruptcy proceedings have commenced. It requires an application by the debtor accompanied by a draft settlement agreement. If the court approves the settlement application, it will make an announcement and convene a creditors' meeting. Secured creditors may exercise their security rights from the date the court approves the settlement.

Once the settlement plan is approved by the creditors' meeting and the court, the administrator is obliged to transfer the business and assets to the debtor. For the plan to become effective, it must be approved by more than half of the creditors with voting rights present at the meeting. The claims represented by such creditors must account for at least two-thirds of the total amount of unsecured claims. If the settlement plan is rejected at the creditors' meeting or by the court, the court will declare the debtor bankrupt.

A settlement agreement that has been approved is binding upon the debtor and the creditors covered by the settlement, i.e. the creditors who held an unsecured claim against the debtor at the time the court accepted the bankruptcy petition. If the debtor is unable or fails to implement the settlement agreement, the court, upon the request of a creditor covered by the settlement, terminates the implementation of the settlement agreement and declares the debtor bankrupt.

Asset Recovery

Moratorium

A moratorium is imposed on the debtor's assets upon acceptance of the bankruptcy application by the court. Upon acceptance of the bankruptcy application, all preservation measures against the debtor's property are lifted and all enforcement actions are suspended. Civil actions or arbitration procedures

that have commenced against the debtor but not completed are stayed. Any repayment of debts to a creditor during this period is deemed invalid.

Collection and Realization of Assets

The debtor is obliged to deliver up its property to the administrator after the court accepts the bankruptcy application. The administrator has a duty to get all the property of the debtor and to prepare asset realisation and distribution plans that are submitted at the creditors' meeting for approval. Unless resolved otherwise at the creditors' meeting, the administrator is obliged to dispose of the debtor's property in the bankruptcy by way of auction. Property that cannot be auctioned off or whose transfer is restricted by state regulations shall be disposed of by those state regulations.

Voidable Transactions

The administrator has the power to investigate and claw back questionable transactions.

The administrator is able to petition the People's Court to revoke transactions entered into within one year preceding the court's acceptance of the bankruptcy application as follows:

- transfers of property for no consideration;
- transactions carried out at markedly unreasonable prices;
- provision of security for unsecured debts;
- premature settlement of undue debts; and
- renouncement of creditors' claims.

Likewise, the administrator can recover debts that have been repaid to individual creditors within the six months prior to the acceptance of the bankruptcy petition, except where the debtor has benefited from such a repayment.

Any transactions that conceal or transfer assets for the purpose of avoiding liabilities, or which fabricate debts or acknowledge a fictitious debt, are deemed invalid by the Bankruptcy Law.

Recovery from Directors and Officers

The administrator is able to recover any irregular income or assets misappropriated from the debtor by its directors, supervisors or senior management using their authority. Directors and officers may also face civil liability if breach of their duties of honesty and diligence resulted in the debtor's bankruptcy. After bankruptcy proceedings are finished, if they are found to be liable, they will be disqualified from being an office-holder of any enterprise for three years.

Cross-Border Insolvency

Bankruptcy proceedings commenced in the PRC pursuant to the Bankruptcy Law cover not only the debtor's assets in the PRC but also extend to its overseas assets. The new legislation also recognises foreign bankruptcy proceedings involving assets in the PRC so as to allow execution in the PRC, provided:

- there are relevant reciprocal treaties between the PRC and the foreign country;
- the foreign bankruptcy proceedings do not contravene the laws, sovereignty, security, or social and public interests of the PRC; and
- the legal interests of creditors in the PRC are not prejudiced.

Out-of-Court Mechanisms

Although the new legislation lays down a framework for restructuring and settlement within the formal bankruptcy process, it is possible for entities to adopt informal measures not involving the court. Informal work-outs or similar options may be an alternative to those parties seeking greater control of the restructuring process and not wishing to be restricted by the requirements under the new legislation.

In the past, when business enterprises were largely state-owned, the rehabilitation of ailing businesses was a process directed by the state. As businesses evolved to include private and foreign interests, the restructuring of an enterprise would have required the approval of, and coordination between, the relevant stakeholders.

Accordingly, as in other jurisdictions, the success of an informal rescue plan in China vastly depends upon the agreement and cooperation between the various factions that, in the case of China, may involve state interests.

Conclusions and Additional Observations

China's bankruptcy legislation encapsulates many concepts familiar to other jurisdictions.

While the current framework of the Bankruptcy Law requires refinement, the law is considered to be a major development for China and provides investors with a unified and comprehensive insolvency regime.

China

Baker & McKenzie
Suite 3401, China World Tower 2
China World Trade Center
1 Jianguomenwai Dajie
Beijing 100004
People's Republic of China

T +86 10 6535 3800
F +86 10 6505 2309

Baker & McKenzie
Unit 1601, Jin Mao Tower
88 Century Avenue, Pudong
Shanghai 200121
People's Republic of China

T +86 21 6105 8558
F +86 21 5047 0020