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Restructuring across borders

China

Corporate restructuring and insolvency procedures | January 2022

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Contents

Introduction

Where a corporate borrower in the People's Republic of China (**PRC**) experiences financial difficulties, the principal restructuring and insolvency options are:

– composition;

– reorganisation;

– informal rescue;

– liquidation; and

– closure.

On 27 August 2006, the Standing Committee of the National People's Congress adopted a corporate bankruptcy law called the Enterprise Bankruptcy Law of the People's Republic of China (the **PRC Bankruptcy Law**), which became effective on 1 June 2007, governing the corporate bankruptcy regime applicable to all enterprises with Chinese legal person status, including domestic companies, foreign investment enterprises, collectively-owned enterprises and state-owned enterprises (**SOE**s).

The PRC Bankruptcy Law does not apply to partnerships or sole proprietors. There is no nationwide personal bankruptcy law either. However, Shenzhen has launched a pilot personal bankruptcy regime as outlined in the Shenzhen Special Economic Zone Regulations on Personal Bankruptcy, which took effect on 1 March 2021. There have been personal bankruptcy cases sanctioned by the local courts in Shenzhen.

This factsheet does not discuss regulations applicable to specific regions.[1]

Creditors with the benefit of security may elect to enforce their security. Security enforcement needs to be initiated by a creditor separately rather than a collective restructuring or insolvency procedure and, if available to a creditor, will often represent the best method of recovery.

1 For example, there are special regulations applicable to the liquidation of an SOE in Beijing which require a group representing the SOE's supervising department to be formed before an SOE may make a bankruptcy application

Enforcement of security

PRC law recognises the following main types of security interests:

– mortgage over real property, plant and machinery, planes and ships;

– pledge over movable properties, equity, stocks, negotiable instruments, intellectual property rights, and those account receivables and other property rights permitted by law and administrative regulations;

– lien over custody contract, transportation contract (possessory lien), maritime lien; and

– floating charge over present and future production equipment, raw materials, semi-finished products and finished products.

The concept of assignment by way of security is only recognised under PRC law to a limited extent. Absolute assignment is therefore commonly used instead. The status of a charge over bank accounts is also unclear and some possibilities to overcome this include contractual account control mechanisms and pledges over fixed, non-fluctuating account balances.

Following the promulgation of the Trust Law of the People's Republic of China, PRC law now recognises the concept of trusts. Accordingly, assets held on trust are considered to be assets of the beneficiary rather than the trustee.

Other than limited exceptions such as stock exchange pledge style repos, in the absence of a consensual enforcement, it is necessary to apply to court for the enforcement of security in the PRC. The court enforcement officers of the relevant basic level people's court will then take control of the enforcement process. They are under no obligation to involve the secured creditor in the enforcement process but in practice would be likely to do so.

In the case of a mortgage, consensual enforcement may take the form of a foreclosure (on terms not prejudicial to the debtor), private sale or public auction. If the enforcement of a mortgage is court-assisted, the enforcement officers will normally dispose of the secured property by way of public auction.

If this is not feasible, for example because the value of the property is deteriorating, or the parties agree otherwise, the court may directly conduct a sale. If neither a court sale nor public auction is possible, the court may transfer title of the property directly to the mortgagor.

An equity pledge may be enforced consensually or with the assistance of the court (subject to the limited exceptions mentioned previously). Similar to the enforcement of a mortgage, the court will first try to auction and sell the pledged equity. If the court is unable to sell the pledged equity by auction or if enforcement is consensual, the pledge equity may be transferred directly to the secured creditor.

Security granted over bank accounts and/or intangible rights can probably only be enforced with court assistance.

Composition

Composition is a restructuring process which provides for an arrangement between the debtor and its creditors to restructure the debtor's debt obligations. The debtor may apply to the court for composition directly or after the court's acceptance of a bankruptcy application (discussed in further detail below) but before the debtor is declared bankrupt. The debtor must prepare and submit a composition proposal.

If the court approves the composition proposal as potentially viable, it will make a public announcement of its ruling and convene a creditors' meeting to consider the composition proposal. A composition agreement must be accepted at a creditors' meeting by creditors: (1) which number at least 50% of creditors attending the meeting who are entitled to vote; and (2) which hold at least two-thirds in value of the unsecured claims of the debtor. The court will then make a ruling to recognise such composition agreement, make a public announcement of its ruling, conclude the composition procedure and suspend any existing bankruptcy proceedings.

The approved composition agreement will be binding on all creditors holding unsecured claims at the time when the court accepted the bankruptcy or composition petition, regardless of whether or not they voted in favour of the composition agreement, and the creditors will only be entitled to repayment in accordance with the composition agreement, unless the debtor fails to comply with its terms.

If the debtor does not, or is unable to, implement the composition agreement, the administrator or other interested parties may apply to the court to terminate the implementation of the composition plan and declare the bankruptcy of the debtor. The debtor will accordingly enter into the bankruptcy liquidation procedure.

If the debtor successfully implements the composition agreement, the debtor will be discharged from all indebtedness which is subject to the composition agreement.

Reorganisation

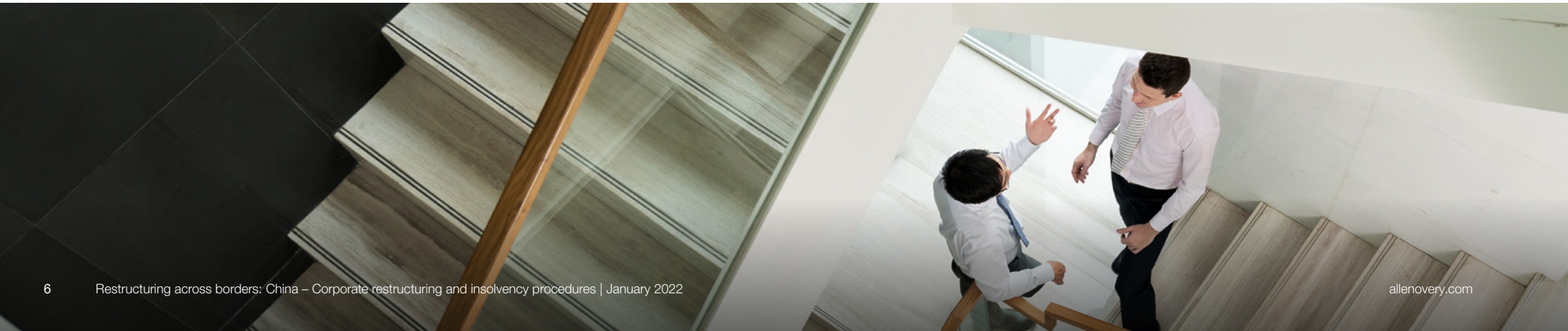
Prior to the PRC Bankruptcy Law coming into effect, PRC law provided very limited scope for any reorganisation proceedings. The PRC Bankruptcy Law makes a modified reorganisation procedure available to restructure both SOEs (without requiring the involvement of the SOE's supervising department) and non-SOEs. The PRC Bankruptcy Law provides that the debtor or its creditors can directly apply to the court for reorganisation. After the court has made a ruling to accept a bankruptcy petition in respect of the debtor, but before the debtor is declared bankrupt, either the debtor, its creditors or holders of more than 10% of the debtor's registered capital may apply to the court for reorganisation.

All legal proceedings against the company (including enforcement of security) are stayed upon the acceptance of the reorganisation petition by the court and may resume when the administrator takes over the debtor's assets.

After the court has approved the application for reorganisation, a reorganisation proposal must be prepared and submitted to the court and the creditors' committee within six months of the date of publication of the reorganisation order, and this period may be extended for a further three months by the court if it is satisfied that there are proper reasons to do so. Under normal circumstances, a court appointed administrator will be responsible for preparing the proposal. Pursuant to Article 73 of the PRC Bankruptcy Law, during the reorganisation period, the debtor may apply to the court to continue to manage its assets and operate its business under the supervision of the administrator. In such a situation, the debtor will be responsible for preparing the reorganisation proposal. Although the PRC Bankruptcy Law makes no provision for creditors to be able to influence the formulation of the proposal, in practice, because the proposal must be approved by creditors, the creditors with the largest sums outstanding are likely to be consulted before the proposal is submitted for approval.

The proposal must be approved at meetings of the relevant classes of creditors (with secured creditors, employees, tax authorities and unsecured creditors as separate classes) by at least 50% in number of those present representing at least two-thirds in value of the relevant class of indebtedness. The court will also need to approve the reorganisation proposal. If the reorganisation proposal is not approved by the creditors or the court, the court will normally terminate the reorganisation proceedings and make a bankruptcy order against the company. However, it is possible for the court to push through a reorganisation proposal against the wishes of some classes of voting groups provided that, amongst other things, the proposal does not harm the interests of secured creditors, employees or the relevant tax authority and the recovery of unsecured creditors will not be less than their recovery in an insolvent liquidation.

Once a proposal has been approved by the court, it will bind all creditors.



Informal rescues

As in the vast majority of jurisdictions, in the PRC it is possible to restructure the debts and the affairs of a debtor through informal out-of-court contractual agreements. However, as a practical matter, such agreements are difficult because employees and other creditors often take steps to enforce their claims through court proceedings or self-help remedies. Although the terms of any such agreement would be negotiated with the management of the debtor, in practice, the creditors would probably have to deal with the municipal government of the relevant province. Higher levels of government may also become involved in the process depending on the importance of the debtor.

Around mid-to-late 2016, against the backdrop of the financial distress resulting from the PRC's overcapacity reduction measures, the China Banking and Insurance Regulatory Commission (the **CBIRC**), the Chinese banking regulator, issued a series of rules encouraging banking financiers to form creditor committees for large companies in financial distress at an earlier stage before formal bankruptcy procedures are initiated.

The CBIRC rules aim to: (1) protect the value of viable companies by enabling them to continue as going concerns with the functioning of creditor committees based on a predominantly out-of-court approach such as a debt rescheduling, restructuring or debt-to-equity conversion; and (2) eventually achieve the broader regulatory objective of safeguarding and stabilising the economic and financial order and supporting the development of the real economy in China. In practice, in most cases the creditor committees would be formed and operate at the informal instruction and under the oversight of the local government or the joint force of relevant authorities.

According to the CBIRC rules, a creditor committee should be an informal organisation formed with at least three banking financiers as sponsors and, operate following the consensual, market-based and self-regulated approach. Once a creditor committee is established, all PRC banking financiers are required to join, whilst other financiers (such as foreign banks) have the discretion but not an obligation to join the creditors' committee.

In practice, with the informal government endorsement, the creditor committees would usually manage to take control over all or at least the majority of the assets of the debtor group.

Members of the creditors' committee would sign a creditors agreement in respect of the structure and governance of the committee, and in most cases, reach a consensus to: (1) take unanimous actions in resolving the claims of the creditors' committee members in a collective manner; and (2) stay unilateral actions.

Liquidation

A solvent "limited liability company" or "company limited by shares" may, in certain cases, be liquidated voluntarily following a shareholders' resolution.

There is no voluntary procedure for the liquidation of an insolvent Chinese enterprise and all such bankruptcies must be declared by the court. The PRC Bankruptcy Law applies to all forms of enterprises with Chinese legal person status.

The debtor or one of the debtor's creditors may apply to the court in the place of residence of the debtor for the debtor's bankruptcy. If the court accepts the application, all civil proceedings, arbitrations and execution proceedings (including enforcement of claims by secured creditors) relating to the debtor will be suspended. Arbitrations and civil proceedings may be resumed after an administrator has been appointed.

On accepting a bankruptcy application, the court will appoint an administrator, who will take over the management of the debtor and have various powers, including the right to apply to the court to nullify transactions at an undervalue during the one-year suspicious period and the right to elect to discharge or continue uncompleted contracts. The administrator will be selected from a group representing members from the appropriate government authorities or organisations, and may be a professional undertaking such as a law firm, accounting firm or insolvency firm or an individual from such a professional undertaking. The administrator will report to the court and shall be subject to the supervision of the creditors, both in general creditors' meetings and, if appointed, through a creditors' committee.

The court will then publish a public announcement and set a timetable for creditors to submit claims. A creditor filing a late claim will not lose the right to claim but will have no right to distributions already made prior to its claim being filed.

The administrator will draft a plan for the disposal of the debtor's assets, which should be adopted by both the creditors' meeting and the court. The usual method of disposing of assets is by way of public auction although this may be varied by the creditors at the creditors' meeting.

In summary, creditors' claims will rank in the following order of priority in the liquidation of a Chinese enterprise:

- secured creditors have priority in respect of the proceeds of the secured assets (subject to employee claims arising prior to 27 August 2006 though pending cases for such claims should be rare, if any);
- liquidation expenses and certain debts incurred for the collective benefit of the estate;
- employees' salaries, medical benefits, allowance for disability and compensation payments;
- outstanding tax payments and social benefit payments; and
- unsecured debt (including the balance of secured claims after realisation of the security assets).

Closure, takeover and others

Closures are a historical special procedure by which relevant authorities may "close" financial institutions. Unlike a formal bankruptcy, there are no detailed rules and procedures governing closures.

The relevant authority (often the People's Bank of China) will make arrangements for the distribution of assets of the financial institution. Traditionally, foreign creditors were paid in full during closures of this type but the closure of Guangdong International Trust & Investment Corporation (**GITIC**) in 1999, in respect of which unsecured foreign creditors received a payout of only approximately 12.5%, showed that this is no longer the case.

That said, we do not observe many closure cases (if any) after the GITIC case. The recent regulatory practice with financial institutions overloaded with toxic assets has shifted to more law-abiding measures, such as regulatory takeover (such as in the case of Anbang group, Baoshang Bank, and numerous financial institutions in the "Mingtian" group, including insurance and trust companies and securities and futures companies), or equity injection in combination with taking over of non-performing loans (**NPL**s) by AMC and AIC[2] (such as in the case of Bank of Jinzhou).

The PRC Bankruptcy Law provides that the State Council may formulate implementing measures according to the PRC Bankruptcy Law or other relevant laws for the bankruptcy of any financial institution. However, although the bankruptcy regime for financial institutions in China has been discussed for years, it remains unclear whether and when such laws would be released and how they would be implemented in the future.

2 AMC stands for financial asset management companies and AIC stands for financial asset investment companies. They are two types of bad-loan managers in China.

Cross-border issues

The PRC has not adopted the UNCITRAL Model Law on Cross-Border Insolvency.

However, the PRC Bankruptcy Law purports to apply to the bankrupt entity's assets outside the PRC. This "long-arm" approach is similar to that found in U.S. bankruptcy law and may result in tensions between overseas insolvency processes (including those in Hong Kong) and a rehabilitation or bankruptcy process commenced in the PRC.

In addition, the PRC Bankruptcy Law provides for Chinese courts to recognise foreign insolvency proceedings that concern assets located in the PRC where: (1) there is an international treaty for recognition with the foreign jurisdiction; or (2) the court determines under the principle of comity that such foreign proceedings do not infringe any fundamental principles of PRC law or impair Chinese sovereignty, national security or public interest or harm the rights of Chinese creditors. There is concern that the courts may interpret this as authority to prefer local creditors rather than strictly applying *pari passu* treatment of all creditors (local and foreign). That said, the recognition of the Mainland insolvency proceedings by the Hong Kong court in the CEFC case and the Shenzhen Everich case, as well as the first recognition of the Mainland insolvency reorganisation in the HNA case, are perceived by many insolvency practitioners in an optimistic way as a prelude for PRC courts to recognise Hong Kong insolvency proceedings under the principle of reciprocity.

On 14 May 2021, the Supreme People's Court of China and the Hong Kong government signed a record of a meeting concerning mutual recognition of and assistance to insolvency proceedings between the courts of the Mainland and Hong Kong. On the same day, the Supreme People's Court of China issued the Opinions on Pilot Program for Recognition of and Assistance to Bankruptcy Proceedings in Hong Kong Special Administrative Region (the **Opinions**). According to the Opinions, liquidators or provisional liquidators in certain Hong Kong insolvency proceedings (the **Hong Kong Liquidator**) may apply to courts in one of the pilot cities (the **Mainland Courts**), namely Shanghai, Xiamen and Shenzhen (the **Pilot Cities**), for the recognition of and assistance to relevant insolvency proceedings in Hong Kong.

The Opinions provide numerous conditions, requirements and restrictions for such recognition and assistance, including:

- the centre of main interest of the debtor should be in Hong Kong continuously for at least six consecutive months before the Hong Kong Liquidator applies to the Mainland Court for the recognition and assistance;
- the types of Hong Kong insolvency proceedings admissible for the recognition and assistance of the Mainland Courts under the Opinions are limited to compulsory winding up, creditors' voluntary winding up and schemes of arrangement promoted by a Hong Kong Liquidator and sanctioned by the Hong Kong court under the Companies (Winding Up and Miscellaneous Provisions) Ordinance and the Companies Ordinance (collectively, **Hong Kong Proceedings**); and
- the principal assets of the debtor in the Mainland are located in one of the Pilot Cities, or the debtor has a business presence (including a representative office) in one of the Pilot Cities.

If a Mainland Court recognises a Hong Kong Proceeding, it should recognise the Hong Kong Liquidator of such proceeding concurrently and announce to the public within five days. The recognition by the Mainland Court has the same implications as the acceptance by a Mainland Court of an onshore bankruptcy petition in terms of automatic stay and no payment being permitted to any single creditor outside of the bankruptcy proceeding.

Once the Hong Kong Proceeding is recognised by the Mainland Court, the Hong Kong Liquidator may apply to the Mainland Court to assume the same duties as those for an administrator in an onshore bankruptcy proceeding, as long as they are within the scope of its duties under Hong Kong law. This is subject to the exception that the disposal of assets (in the Mainland) by way of abandon, creating securities, granting loans, transferring assets abroad, or in any other way that would have a material impact on the interests of creditors requires separate approvals by the Mainland Court.
The Hong Kong Liquidator or debtor may also choose to apply to the Mainland Court to appoint an onshore administrator to assume the same duties (which are subject to the same restrictions).

Cross-border issues (cont.)

Note that the bankruptcy property of the debtor in the Mainland should be firstly applied to satisfy preferential claims under PRC law, and then be distributed in accordance with the Hong Kong Proceeding, provided that creditors onshore in the PRC and offshore in the same class are treated equally.

The Opinions also specify a number of circumstances requiring Mainland Courts to refuse to provide recognition or assistance. These include that the debtor does not meet the insolvency test under article 2 of the PRC Bankruptcy Law, unfair treatment of creditors in the Mainland, violation of basic principles of PRC law, offence to public order or good morals or any other circumstance where Mainland Courts consider that recognition or assistance should not be rendered.

The Opinions require Mainland administrators and Hong Kong Liquidators to strengthen communications and cooperation if the same debtor or affiliated debtors are in bankruptcy proceedings in the Mainland and Hong Kong concurrently.

The first application for the recognition of and assistance to insolvency proceedings in Hong Kong pursuant to the Opinions was submitted to the Shenzhen Intermediate People's Court (the **Shenzhen Court**) in the Samson case. The Shenzhen Court issued an announcement to acknowledge the receipt of the application in this case and held a hearing in September 2021. It remains to be seen how the case will progress.

As a final matter, we are obliged to point out that foreign lawyers such as ourselves are not permitted to practise PRC law or give opinions on PRC law. The views and comments set forth in this factsheet have been made on the basis of our experience and knowledge of the laws currently in force in the PRC as published by the PRC authorities and our discussions with PRC officials on a no-name basis, with contributions of Shanghai Lang Yue Law Firm. They do not constitute legal advice. Should you wish to obtain an opinion from PRC qualified lawyers, we will be more than happy to assist you in arranging for it.

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Further information

Developed by Allen & Overy's market-leading Restructuring group, "**Restructuring Across Borders**" is an easy-to-use website that provides information and guidance on all key practical aspects of restructuring and insolvency in Europe, Asia, the Middle East and the U.S.

To access this resource, please click **click here**.

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