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# Restructuring Across Borders

## People's Republic of China:

Corporate restructuring and  
insolvency procedures | May 2020







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# 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 (**SOEs**).

As the PRC Bankruptcy Law does not apply to partnerships or sole proprietors, the PRC remains without any personal bankruptcy law.

This factsheet does not discuss regulations applicable to specific regions.<sup>1</sup>

Creditors with the benefit of security may elect to enforce their security. Security enforcement is essentially a self-help remedy rather than a collective restructuring or insolvency procedure and, if available to a creditor, will often represent the best method of recovery.

<sup>1</sup> 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 not recognised under PRC law. 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 its debt obligations. The debtor may apply to the court for composition even 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 and suspend the bankruptcy proceedings. The approved composition agreement will be binding on all creditors holding unsecured claims at the time when the court accepted the 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 creditors may apply to court for resumption of the bankruptcy proceedings.

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 after the court has made a ruling to accept a bankruptcy petition in respect of a 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.

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, which 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 and 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 upon 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 Chinese banking regulator CBIRC (ie China Banking and Insurance Regulatory Commission) 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: (i) 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 (ii) eventually achieve the broader regulatory objective of safeguarding and stabilising the economic and financial order and supporting the development of 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 is to 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, while 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: (i) take unanimous actions in resolving the claims of the creditors' committee members in a collective manner; and (ii) 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 within 12 months from the date of his or her appointment 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, 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 arising after 27 August 2007; 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 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 have been shifted to more law-abiding measures, such as regulatory takeover (such as in the case of Anbang group and Baoshang Bank), or equity injection in combination with taking over of NPLs by AMC and AIC<sup>2</sup> (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 future.

<sup>2</sup> 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 first recognition of the China mainland insolvency proceedings by the Hong Kong court in the CEFC case recently, is perceived by many insolvency practitioners in an optimistic way as a prelude for PRC courts to recognise Hong Kong insolvency proceedings in the principle of reciprocity.

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. 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.

# Key contacts

If you require advice on any of the matters raised in this document, please call any of our partners or your usual contact at Allen & Overy.



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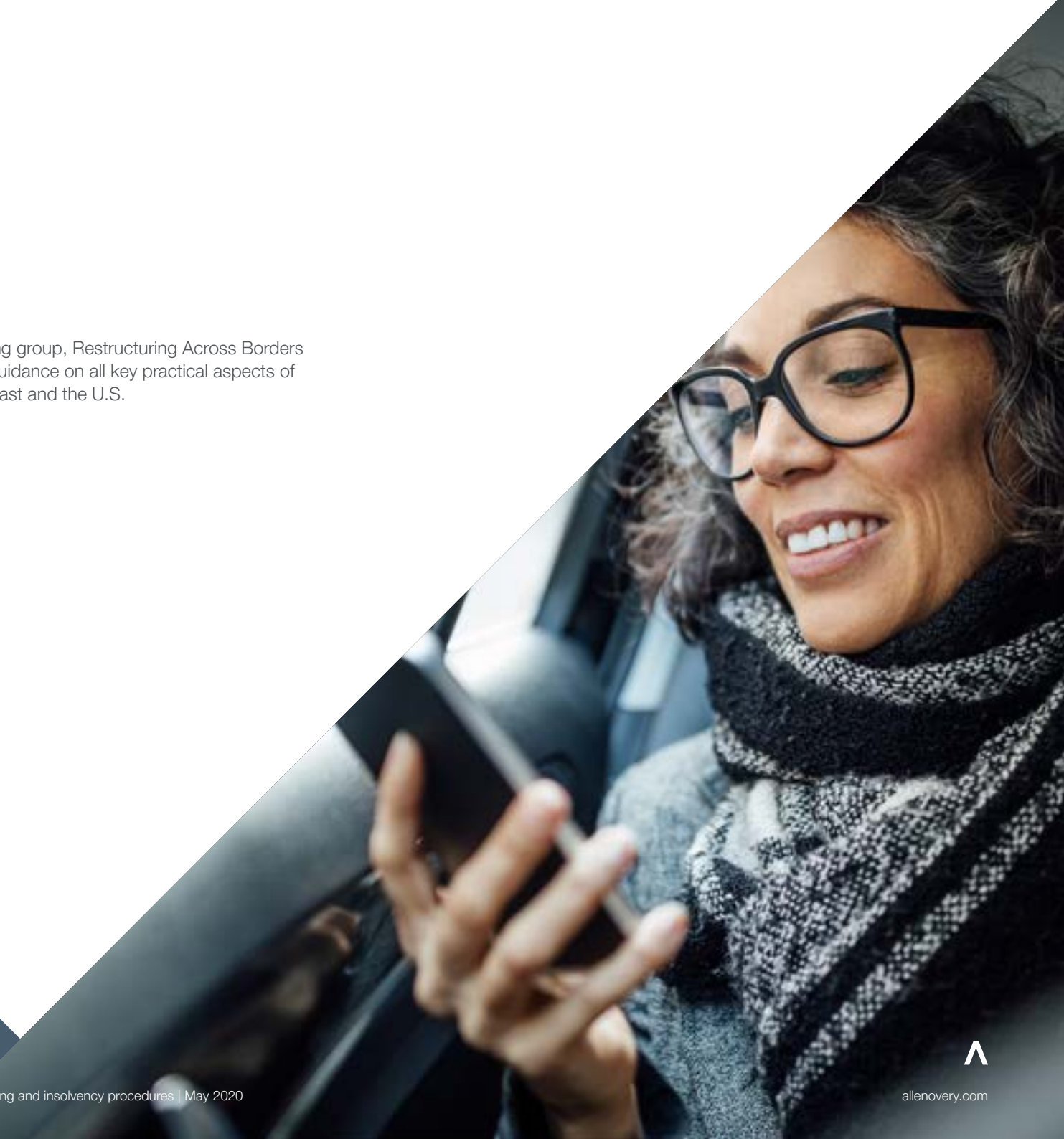




# Further information

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 [here](#).



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