

China Continues to Issue New Rules Promoting Corporate Rescue Culture, Facilitation of Bankruptcy Proceedings

By Xiao Ma (Reorg | Harvard Law School)

Coupled with continued efforts in financial deleveraging and industrial reorganization, China delivered a number of changes to its bankruptcy law in 2019 in an effort to further accommodate smooth market exits for non-profitable businesses and to provide greater opportunities for viable businesses that experience temporary liquidity issues to be restructured as going concerns.

Currently, a lack of detailed rules and practical solutions to issues arising out of bankruptcies often deters parties from initiating such proceedings in China. The new rules will provide further clarification on extensively litigated/disputed issues and enhance transparency and consistency in the bankruptcy courts' handling of cases. The developments encourage more usage of restructuring and compromise proceedings to find market solutions to address insolvency of Chinese companies.

"China's bankruptcy laws and practices will be more and more market-driven," said Xu Shengfeng, a Shenzhen-based bankruptcy and restructuring partner of Zhong Lun Law Firm, notwithstanding perceptions among foreign investors that "China's bankruptcy regime is rather bureaucratic and administrative, with a certain level of involvement by local governments."

"The goal is to build an institution in which the government's role can be minimized, until its complete exit," Xu said. "It cannot be done within a year or two, but this is certainly where things are headed."

Market players, in particular financial institutions and asset management companies, are becoming more active and playing a greater role in leading restructuring and compromise proceedings. "Right now, many of the restructuring cases need capital injection from outside investors, and it is a great time for asset management companies," Xu said. The recent U.S.-China Trade Deal promises to open doors for U.S. firms to obtain asset management licenses to acquire Chinese NPLs – see Article 4.5 of [the US-China Economic and Trade Agreement](#).

Key changes to China's restructuring regime in 2019 included:

- establishment of specialized bankruptcy courts in Beijing, Shanghai, Shenzhen, Tianjin, Guangzhou, Wenzhou and Hangzhou;
- Supreme People's Court's Judicial Interpretation III on the Enterprise Bankruptcy Law (EBL);
- joint announcement of the Plan for Accelerating Improvement of the System for Market Entity Exits by 13 major state departments;
- further establishment of regional bankruptcy administrator associations, including those in Beijing and Shanghai;

- comment solicitation and final issuance of the Minutes of Conference on National Courts' Civil and Commercial Trial Work, which devoted a section specifically for amendment of bankruptcy rules and restructuring regimes; and
- launch of [National Enterprise Bankruptcy Information Disclosure Platform](#), a platform for the public to access information related to bankruptcy cases and facilitate bankruptcy proceedings in terms of claim registration, notices for creditors' meeting, publication of announcements, etc.

"It was definitely a year of highlights," said Xu. "The professionalism of bankruptcy trial teams, the establishment of online bankruptcy information disclosure platform, the promotion of pre-packaged restructurings and so on. The Supreme People's Court is also making headways in the areas of personal bankruptcy and cross-border bankruptcy."

Update on New Rules

On Nov. 14, the Supreme People's Court published the Minutes of Conference on National Courts' Civil and Commercial Trial Work. The minutes included setting out 130 articles which addressed difficult restructuring issues that emerged from previous and live cases. Although the minutes are non-binding (i.e. not formally a legal authority), Chinese courts are expected to follow the principles and rules provided in the minutes in resolving civil and commercial disputes.

The relevant bankruptcy/restructuring section of the minutes - Articles 107 to 118 - emphasizes the importance of properly resolving bankruptcy cases as part of the nation-wide campaign on deepening industrial structural reform and providing a stable, fair, transparent and consistent business environment.

Current policy orientations are focused on:

- promotion of a corporate rescue culture to maximize the interest of relevant parties;
- utilization of compromise proceeding and facilitation of pre-packaged deals that preserve the going concern value of businesses and the jobs the debtor company created;
- reduction of non-profitable "zombie companies" that no longer conform to national industrial policies and the simplification of their liquidation proceedings;
- improvement of bankruptcy proceedings' economic efficiency; and
- implementation of legislation to create a personal bankruptcy regime.

In addition, the minutes provide new rules that aim to flesh out the general policy guidance and help reduce commercial doubt over practical issues. The key changes/guidance are set out below:

- *Bankruptcy Filing.* Articles 107 & 108 provide that courts must accept bankruptcy filings and should not stay passive for the sake of "social stability". Bankruptcy cases can be registered online at National Enterprise Bankruptcy Information Disclosure Platform and,

if there is any missing information, the relevant court department must notify the filing party accordingly and move the case forward for substantive review and formal acceptance in a timely manner. The compromise proceeding - a part of China's bankruptcy regime that has been long neglected and rarely used - is emphasized to be used to improve efficiency. When a creditor files for bankruptcy of a debtor but is repaid thereafter, the creditor can withdraw the filing (before the formal case is accepted by the relevant court - although parties cannot withdraw bankruptcy filings after a court formally accepts the case) but cannot prevent other qualifying creditors or the debtor itself from filing again. Such repayment, if it constitutes a voidable transaction under the EBL, can be clawed back upon an application by the administrator.

- *Bankruptcy Estate.* Article 109 provides that upon the acceptance of a formal case, asset preservation measures against the debtor should be released and enforcement actions should be suspended. A debtor's assets should be promptly handed over to the appointed administrator so as to preserve the bankruptcy estate. If the debtor's assets are controlled or preserved by another state enforcement agency, the relevant court should take the proactive role to negotiate and coordinate among agencies and to move those assets back to the bankruptcy estate. This rule is particularly useful as there are a number of bankruptcy cases which include an element of fraud and the defrauded party may have initiated criminal proceeding against the debtor. Under the guidance of this rule, the bankruptcy proceeding prevails (in terms of asset distribution) and the relevant asset should be put back into the debtor's general pool of assets for potential distribution among all the debtors creditors instead of exclusively for the one defrauded party. This rule also applies to other administrative claims against the debtor's assets from tax and custom agencies.
- *Pending Lawsuits.* Article 110 emphasizes the coordination between bankruptcy court and other courts in pending civil and commercial lawsuits. When a debt confirmation lawsuit has started but is pending before a bankruptcy case is formally accepted, the relevant creditor can still register its claim but cannot vote in the debtor's bankruptcy proceeding unless its debt amount is tentatively or finally confirmed by a court. After a bankruptcy case's formal acceptance, creditors can no longer file a debt confirmation lawsuit but only register its claim with the appointed administrator. Challenges can be made if the creditor disputes the debt amount as confirmed by the appointed administrator.
- *Quasi-DIP.* Article 111 provides further clarification on how to initiate and implement something similar to the U.S.-style "debtor-in-possession" restructuring. The gateway has been in place since the introduction of the EBL (Article 73 of the EBL) but has rarely been used previously due to a lack of guidance. During the restructuring proceeding, upon application, the court may approve the debtor managing its assets and operating on its own, if the debtor fulfills all of the following conditions:
 - the debtor's internal governance mechanism is still functioning normally;
 - self-management by the debtor is beneficial for the debtor's continued operation;

- the debtor has committed no act of fraudulent asset transfer; and
- the debtor has no other act that is severely detrimental to the interest of creditors.

The application can be made by the debtor itself and alongside its bankruptcy/restructuring filing. Once approved, the relevant powers and responsibilities of the administrator (as designated under the EBL) are performed by the debtor under the administrator's supervision. If the administrator or other relevant party finds any of the debtor's acts to be "severely detrimental" to the interests of creditors, it can apply to the court to stop the "debtor-in-possession."

Chen Xiahong, researcher at Research Institute of Bankruptcy Law and Corporate Restructuring at China University of Political Science and Law, said there is a crucial difference between China's quasi-DIP and its U.S. counterpart. "DIP is a mainstay in U.S. chapter 11," said Chen. "In other words, any business enterprise upon entering bankruptcy, barring any surprise development, normally would adopt DIP. It's the norm."

"However, in China according to EBL, all business enterprises regardless of what proceedings they enter, an administrator has to be appointed first," said Chen. "In other words, management by administrator is the norm, while self management by debtor is the exception."

- *Security Enforcement.* Article 112 provides that, in order to balance the interest of security holders and restructuring value of the debtor, the administrator or the debtor must determine if any of the assets subject to security are required as part of the restructuring of the debtor. If an asset subject to security is not required, the administrator or the debtor must sell or auction the assets with the proceeds from the sale, minus relevant expenses, applied first for the repayment of the security holder. If a secured asset is required for the restructuring and the relevant security holder is provided with a guarantee or compensation for any potential diminished value, the enforcement of the security can be suspended.
- *Pre-packaged Restructuring.* Article 115 recognizes the validity of restructuring agreements reached by parties in a pre-pack deal. To further improve efficiency and combine out-of-court and in-court restructuring efforts, the court is guided to regard a parties' consent, provided in an out-of-court restructuring agreement, as automatically consenting to an in-court restructuring proposal if the content of the in-court proposal is substantially the same as the out-of-court agreement. However, for protection, if the in-court restructuring proposal amends the agreed out-of-court restructuring agreement in a way which has a negative impact on creditors' rights, or the amendment concerns major interests of relevant parties, those affected parties are provided with another opportunity to vote and consent to the in-court proposal.
- *Responsibility of Relevant Personnel.* In liquidation cases where relevant employees of the debtor are missing or the details of the debtor's properties cannot be located, the

court may pursue legal action against the shareholders and management including under criminal law, order border restrictions and other measures. The court is guided to consider the principle of creditor protection as well as refrain from unnecessarily piercing the corporate veil which would result in the relevant shareholder sharing the financial liabilities of the debtor company.

The above guidance updates from the minutes represent positive developments to China's bankruptcy laws, with the inclusion and focus on such concepts as "debtor-in-possession" and "pre-packaged restructuring" being adopted and elaborated on. However, it remains to be seen how these rules are implemented and how they interact with the existing bankruptcy institutions in China.

Recap of Current Laws

The bankruptcy laws that are currently in force in China generally refer to the Enterprise Bankruptcy Law (EBL) enacted in 2006 and entered into force on June 1, 2007, together with the three judicial interpretations issued by the Supreme People's Court in 2011, 2013 and 2019, respectively. The EBL has been used for over a decade but has become more prominent in recent years with the economic slowdown and industrial reform in China, which led to more bankruptcy filings including several market-driven restructurings.

The EBL takes elements from the U.S. Bankruptcy Code and U.K. administration regime, with the construction of three major bankruptcy proceedings to choose from: liquidation, restructuring or compromise, and parties can convert one proceeding to another when certain conditions are met.

Liquidation is a collective proceeding to distribute the debtor's assets to its creditors, and after which the debtor will no longer exist. Restructuring, conversely, gives the debtor an opportunity to emerge from bankruptcy and continue operating if a court-approved deal can be reached among parties. Compromise can only be initiated by the debtor and applies to its unsecured creditors only. It is usually used to confirm a standstill agreement or waiver of debt by these compromising creditors.

Key elements of the EBL include the following:

- *Insolvency Test:*
 - In respect of a debtor commencing bankruptcy or a compromise proceeding, the EBL adopts a hybrid insolvency test combining balance sheet and cash flow tests. A company is deemed insolvent when (a) it cannot repay its debts as they fall due; and (b) its assets are insufficient to cover its debts or obviously lacks the ability to repay its debts. If the company satisfies this test, it can enter into any of the three proceedings under the EBL to restructure its debts. To commence restructuring proceedings the company needs to illustrate that on a balance of probabilities, it will lose the ability to repay its debts.

- A creditor can apply to initiate bankruptcy or restructuring proceedings if it establishes that the debtor is unable to pay its debts as they fall due.
- *Moratorium.* The EBL provides that upon the court's acceptance of a bankruptcy filing, all asset preservation measures over a debtor's assets are released, enforcement actions against the debtor, pending lawsuits and arbitration proceedings suspended, and individual repayment to creditors stopped. The moratorium is limited to the extent that: (i) there is always a window between the bankruptcy filing and the formal case acceptance by the court; (ii) the pending lawsuits and arbitration proceedings can be resumed once an administrator is appointed.
- *Filing Party and Jurisdiction.* The debtor itself can file for liquidation, restructuring or compromise, whilst a creditor who has an outstanding debt claim against the debtor can file for its liquidation or restructuring. The court of the debtor's place of domicile has exclusive jurisdiction over its bankruptcy proceedings.
- *Appointment of Administrator.* The court will appoint an administrator to oversee the debtor's bankruptcy proceedings and mainly focuses on preserving and allocating the debtor's assets. The administrator is usually appointed by the court through a lottery system which selects from a roster of qualified administrators - mostly accounting firms, law firms, specialized liquidation firms or other similar agencies - of the relevant provincial/municipal jurisdiction or through a bidding process for high-profile and complex cases. Once appointed, an administrator will: (i) take over control of the debtor's assets, books, chops and documents; (ii) investigate the financial situation of the debtor; (iii) determine the operational matters of the debtor as well as daily expenses; (iv) decide on whether to continue or suspend the debtor's businesses before the first creditors' meeting; (v) manage and dispose of the debtor's assets; (vi) attend lawsuits, arbitrations and other legal proceedings on behalf of the debtor; (vii) summon a creditors' meeting and deal with other matters as the court deems appropriate. The administrator's compensation will be paid with priority by the debtor's estate, and will report to the court and will be supervised by the creditors' committee.
- *Executory Contracts.* Executory contracts, or those entered into prior to the initiation of the bankruptcy proceeding but not performed or only partially performed, will be deemed terminated unless the appointed administrator determines to continue performance within the first 60 days of the bankruptcy proceeding.
- *Transaction Avoidance, Fraudulent Transfer and Preference.* Certain transactions can be voided if they took place within a year prior to the court's acceptance of the bankruptcy case, including: (i) transfer of assets without consideration; (ii) transactions at an undervalue; (iii) creation of new security for an existing debt; (iv) advance debt repayment before the debt is due; and (v) waiver of debts. Fraudulent transfers can be declared void by the court upon an administrator's application. Preferential payments which took place within six months prior to the acceptance of the bankruptcy case can

also be voided if the debtor met the insolvency test at the time, except for payments that are beneficial to the estate of the debtor.

- *Distribution Waterfall.* The debtor's assets shall be distributed in the following order of priority: (i) secured debts to the extent of the value of the security; (ii) administrative bankruptcy expenses and other debts of common interests incurred for the benefits of the debtor's estate; (iii) obligations to employees including wages, medical and disability subsidies, pension contributions and other compensations as required under the law; (iv) tax obligations; and (v) other unsecured debts.
- *Creditors' Meeting and Voting Mechanism.* Voting takes place at creditors' meetings on major decisions in relation to the debtor's operations, management of the bankruptcy proceedings and relevant distribution plans. Each creditor that has registered a claim in the bankruptcy should have voting rights. For resolutions to be adopted at a creditors' meeting, more than half of the creditors that attend the meeting and represent more than half of the total amount of outstanding debts need to approve them. For voting on a proposed restructuring plan, creditors are divided into different classes including: (i) secured creditors; (ii) employee creditors; (iii) tax creditors; and (iv) other general unsecured creditors. The administrative expenses and debts of common interests are not mentioned in the creditor classification thus are likely be pay-as-you-go. A proposed restructuring plan must be approved by each class of creditors, and within each class by more than half of the creditors that attend the meeting and represent more than two thirds of the total amount of debt held in that class.
- *Creditors' Committee.* Creditors can resolve to establish a creditor's committee. The creditor's committee will consist of representatives as appointed by the creditors' meeting plus one employee or labour union representative, and cannot exceed nine members. The members of the creditors' committee must be confirmed by the court in writing. The creditors' committee takes responsibilities of matters resolved at a creditors' meeting, supervises asset disposals and allocations and call creditors' meeting. The administrator will report to the creditors' committee (instead of the court if otherwise) and the creditors' committee can make inquiries to the administrator's work and demand documents from relevant employees of the debtor.
- *Cram-down Mechanism.* The court may cram down a restructuring plan over dissenting creditors if all of the following conditions are met: (i) the secured creditor class has approved the plan, or if not, their interests will not be materially impaired by the restructuring plan with reasonable compensation in relation to their losses arising out of the delay in repayment; (ii) employee and tax creditors will be paid in full, or if not, their respective classes have approved the restructuring plan; (iii) under the proposed restructuring plan, the repayment to the general unsecured creditors will be no less than the liquidation value that they would be entitled to if there were a liquidation proceeding at the time of approving the reorganization plan, or they have approved the restructuring plan as a class; (iv) any adjustment of the shareholders' rights and interests is fair and

equitable, or shareholders have approved the restructuring plan as a class; (v) members of the same class of creditors are treated *pari passu*, fair treatment is provided in accordance with the distribution order as designated by law; (vi) a debtor's operation plan under the restructuring plan is feasible.

- *Enforcement of a Restructuring Plan.* Once a restructuring plan has been approved by the creditors and the court, the debtor will be responsible for its implementation and report to the administrator during a supervision period as provided in the restructuring plan. Upon expiry of the supervision period, the administrator will submit a report to the court and conclude its supervision over the debtor. If the debtor fails to implement the restructuring plan, the court can order the termination of the restructuring proceeding and declare the debtor bankrupt. The debtor will then be put into liquidation.

In addition to the above, there are various documents and rules clarifying how to deal with complex situations arising out of bankruptcy proceedings.

For example, concepts such as piercing the corporate veil and substantive consolidation have been repeatedly raised by creditors in cases where they suspect fraudulent acts by the shareholders of the debtor company or related transactions among affiliated parties which have resulted in a mingled asset pool between group companies. These have led to heated debates among practitioners and judges regarding how to address these issues as well as maintain the proper boundary of bankruptcy law without unnecessarily disrupting or intervening other areas of law with established doctrines.

An earlier Minutes of Conference on National Courts' Bankruptcy Trial Work of 2018 set out that substantive consolidation can only be used in exceptional cases when: (i) the legal personalities of affiliated parties are highly mixed; (ii) it would be too costly to differentiate assets of affiliated parties; and (iii) the situation severely impairs creditor's fair recovery.

Cross-border Developments and Future Outlook

The Hong Kong court has recently recognized mainland administrators for the first time to facilitate a Chinese liquidation proceeding – *CEFC Shanghai International Group Limited (in Liquidation in the Mainland of the People's Republic of China) [2020] HKCFI 167 (date of judgement 13 January 2020)*. Chinese practitioners anticipate more cross-border cases to arise in the next few years and the Supreme People's Court has been actively working on promoting a linkage between mainland and Hong Kong bankruptcy proceedings. According to Zhong Lun's Xu, Shenzhen Intermediate People's Court and the High Court of Guangdong Province are in close communication with Hong Kong bankruptcy community regarding establishing an efficient cross-border bankruptcy regime in the Greater Bay Area of Guangdong, Hong Kong and Macau.

In terms of reciprocity between the Chinese courts and other foreign courts for the recognition of bankruptcy proceedings, the U.S. courts have recently recognized the Chinese bankruptcy

proceeding of Reward Science and Technology Industry Group Co., Ltd. through a chapter 15 filing - *In re Reward Science and Tech. Industry Grp. Co, Ltd., Case No. 19-12908 (MEW)* (Bankr. S.D.N.Y. September 9, 2019)

“As far as I know, certain Chinese courts are quite open-minded and hope there will be applications and cases to prompt this development,” Xu said. “The legal basis is Article 5 of the EBL, and it’s been there all the time, except that no real case to test it and give the court a chance to clarify on how to apply. Sometimes applicants are deterred by conservative advice provided by professionals who are not particularly familiar with the market.”

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