



CHINA: ENTERPRISE INSOLVENCY & RESTRUCTURING

In 2007, China introduced a comprehensive enterprise insolvency law (**EIL**) applicable to all kinds of companies registered in China, irrespective of their nature as foreign, domestic or State invested.

Insolvency Test & Commencement of Proceedings

Under the EIL, enterprises qualify for insolvency, restructuring or settlement if

- they are unable to repay their debts,
- their assets value at a lesser amount than their liabilities, or if
- they are otherwise obviously incapable of paying off their debts when due.

Either the debtor (i.e. the distressed enterprise itself) or any of its creditors from inside or outside China can apply for insolvency proceedings at the People's Court in charge of the insolvent enterprise¹. If outside China debtors file such applications, some of the application documents concerning the debtor may need to be notarized, legalized and authenticated abroad where the non-PRC debtor resides. Otherwise, Chinese and foreign creditors enjoy equal legal rights and treatment in applying for an insolvency proceeding of one of their China debtors.

The EIL does not oblige the debtor to file insolvency proceedings within a certain period as of one of the above reasons for qualifying to file for insolvency, restructuring or settlement having arisen. Hence, there is no legal consequence in the EIL itself if the debtor fails to do so. However, the debtor (and in certain cases even its shareholders) may be subject to liability based e.g. on corporate, civil or even criminal legal provisions if their apparent failure and omission to file for insolvency proceedings has caused third parties losses and damages which were foreseeable and could have been avoided by a timely filing of bankruptcy procedures.

¹ Exception: If the insolvent entity is a financial institution, the insolvency application shall be filed by the competent PRC banking regulatory authorities.

Claims Filing / Set-off / Debt-ranking

Secured and unsecured creditors must file their claims within a deadline devised by the court in-charge. Such claims filing period can be between 30 days to three months, starting from the day the court accepted the insolvency application by the debtor or a creditor. Claims qualifying for filing include e.g.

- (Un-)matured debts existing upon the day the court accepted the insolvency application by the debtor or (joint) creditors
- Debts subject to certain conditions/deadlines
- Claims raised but not adjudicated in courts/arbitration commissions upon the day the court accepted the insolvency application by the debtor or a creditor
- Security obligations owed to guarantors of the debtor
- Civil liability claims for losses and damages under agreements/contracts terminated by the administrator or the debtor according to the EIL

If creditors would like to set-off any of their debts owed to the debtor and that incurred before acceptance by the court of the insolvency application, they can request the administrator to set off their debts against their claims against the debtor. The administrator shall deny such request if the creditor knew or should have known about the debtor's inability to repay its debts, unless the debt incurred over 2 months prior to the insolvency application or is otherwise due according to law.

Under the EIL, debts are serviced in the following order:

- Insolvency expenditures
- Common interest debts
- Employee claims
- Social insurance premiums and outstanding taxes
- Unsecured claims

If the debtor's assets do not cover the payment of all confirmed claims of a certain rank, the settlement within such rank will be handed on a pro rata basis. Secured creditors enjoy priority in regard to the secured amount.

Role of Administrators

Once the locally competent court accepted an insolvency application, the court appoints an insolvency administrator. In practice, these are mostly PRC-qualified legal, accounting or specialist insolvency firms who have particular expertise and know-how in handling such procedures. These administrators get selected and compensated in accordance with the guidelines devised by the PRC Supreme People's Court.

Administrators report to the People's Court that appointed them. The work of the administrators is supervised and approved by the creditors' meeting, which may also request to replace and remove administrators who fail to perform their duties lawfully, impartially or otherwise without the due competence. If administrators are found to have violated their lawful duties, they can be fined and held liable for losses caused to creditors, debtors and other third parties.

In carrying out their tasks, administrators shall in particular discharge the following duties:

- Control debtors' assets, official chops, all accounting materials and bank accounts
- Clarify and report the debtors' financial status
- Handle the debtors; internal management and routine expenses
- Manage the debtors business operations prior to the first creditors' meeting (including the right to decide to (dis-)continue operations)
- Handle and dispose of assets of the debtors
- Act as representative of the debtors in any legal proceedings and propose sessions of creditors' meetings
- Handle other assignments according to law and/or required by the competent courts

Role of Creditors' Meetings

The most powerful organ in an insolvency process is the creditors' meetings (aka creditors' committee). In general, all (un-)secured creditors who filed claims in an insolvency process are invited to participate and vote at such creditors' meetings, whereby e.g. the following exceptions apply:

- Secured creditors cannot vote on settlement/distribution plans, unless they have waived their right to priority;
- Creditors whose claims have not been confirmed cannot vote at all, unless the competent court tentatively confirmed the claim for the purpose of giving the creditor the right to vote

Decisions by creditors' meetings require a simple majority of voting rights of creditors being present at a meeting and holding at least 50% of the value of unsecured debt.

In carrying out their tasks, creditors' meetings shall in particular discharge the following duties:

- Supervise administrators
- Verify creditor claims
- Select members of the creditors' committee
- Request courts to replace/remove administrators
- Decide on the (dis-)continuance of business operations of the debtor
- Approve restructuring/settlement plans
- Approve all measures to handle, liquidate and distribute assets of debtors
- Handle other assignments according to law and/or required by the competent courts

In particular in larger creditors' meetings, also often a creditors' committee of up to nine members can be elected by the creditors' meeting from among its members. If established, creditors' committees must include an employee or trade union representative of the debtor. The creditors' meeting can then decide which duties in particular to delegate to the creditors' committee.

Restructuring & Settlement

Acceptance of an insolvency application by the court does not necessarily lead to the winding up of the debtor company. Under the EIL either the debtor or the creditors can file an application for restructuring, reorganization, compromise or settlement before the debtor is declared insolvent.

RESTRUCTURING

If an application for restructuring is filed, either the debtor or the administrator must submit a draft restructuring plan to the court and the creditors' meeting within six months (or within an extended period of nine months subject to court consent) 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.

In such case, the court shall call on the creditors' meeting to convene within 30 days to vote on the draft and the creditors will be allocated into the following voting groups:

- Creditors with secured claims over specific properties of the debtor
- Employees with claims on salaries, medical/disability subsidies, basic pension/medical insurance premiums, compensation payable to individual employee accounts according to law
- Claims for outstanding taxes
- Unsecured claims

Secured creditors' rights over pledged assets are suspended during the restructuring period but the secured creditors may apply to the court to enforce their secured rights if there is a proven risk of damage or devaluation to the secured asset.

The draft restructuring plan must be approved by a majority number of creditors in each voting group, and the amount of claims they represent must account for at least 2/3 of the total amount of claims in that group. If that is not the case, the debtor or administrator may still request the court to approve the plan under certain conditions. If the plan eventually fails to get the necessary approval, the court will declare the debtor insolvent.

If the plan obtains the necessary approval, the debtor must implement the restructuring plan during the supervision period decided by the court and once approved, the plan is binding on the debtor and all creditors. The administrator will supervise such implementation and request the debtor to report on the process. If the debtor fails to implement the restructuring plan as approved, the court will declare the debtor insolvent upon petition from the administrator or any materially interested party.

The court may also declare the debtor insolvent during the restructuring period under any of the following circumstances:

- the debtor's business/financial status deteriorates further without hope to be rescued
- the debtor commits fraud, disposes of assets in bad faith or otherwise acts to the detriment of the creditors
- the administrator cannot discharge his duties because of the acts or omissions of the debtor

SETTLEMENT

Settlement allows debtors to compromise its debts directly with its creditors after the insolvency proceedings have commenced. It requires an application by the debtor accompanied by a draft settlement agreement. If the court approves the application, it will convene a creditors' meeting. Secured creditors may exercise their security rights from the date the court approves the settlement. Once the agreement is approved by the creditors' meeting and the court, the administrator is obliged to transfer the business and assets to the debtor and such agreement is then binding on the debtor and the creditors covered by the settlement. The agreement must be approved by at least 50% of the creditors being entitled to vote at the meeting and the claims represented by them must reach at least 2/3 of the total amount of unsecured claims. If the agreement is not approved by the necessary majority of creditors or by the court, the court will declare the debtor insolvent. Likewise, the court will declare the debtor insolvent if he fails to implement the agreement.

INSOLVENCY AND VALIDITY OF CONTRACTS; ASSET PRESERVATION

Administrators may terminate commercial contracts which were concluded but not fully performed prior to acceptance of the insolvency application by notifying the contract parties. Provided the Administrators do not notify the contractual parties of such termination within two months of the court's acceptance of the insolvency application or if the administrators within 30 days after receiving a exhortation notice from the contract party do not give any reply, such contracts shall also be deemed terminated. If the administrator wishes to perform the contract, the other party may ask for a guarantee

and if that is not provided the contract shall be considered terminated. Termination in accordance with this chapter entitles the other party to claim compensation for losses suffered because of such termination.

Administrators may also request the court to nullify transactions having occurred within one year before the court accepted an insolvency application in the following circumstances:

- Assets were transferred without compensation
- Transactions were handled based on compensation rates materially beyond reasonable rates
- Security was provided for unsecured debt
- Undue debts were settled early for no reason
- Debtors waived their claims as creditor

Administrators can also

- Request repayment of sums paid to individual creditors within six months before the court accepted an insolvency application, unless such payment by the debtor was advantageous to the debtor
- Rescind any transactions as invalid which
 - concealed or transferred assets of the debtor to evade liabilities, or
 - fabricated debts or accepted fictitious debts

Administrators are also entitled to recover irregular income or assets misappropriated from the debtor by its directors, supervisors or senior managers and such group of officers shall also bear civil liability if the insolvency occurred due to their breach of duty to act in good faith and with diligence. If they are thus found liable, they will lose their legal qualification to hold such position in another entity for at least three years.

Once a court accepts an insolvency application, all property preservation measures against assets of the debtor and all related enforcement measures are suspended. Civil legal and arbitration processes which were initiated but not completed at the time when the court accepts an insolvency application are halted. During such suspension/halting periods, payments of debts to creditors are considered invalid.

Debtors must declare and deliver all their property inside and outside China to the administrators who then must prepare asset realisation and distribution plans for approval by the creditors' meeting. Unless resolved otherwise at the creditors' meeting, administrators shall auction off all assets of the debtor. Assets that fail to be auctioned off or which cannot be legally transferred in that way must be liquidated according to law.

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