



# The Asia-Pacific Restructuring Review 2018



# China

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## A changing landscape

A decade ago China took a big step forward when it gave effect to the country's first consolidated national corporate bankruptcy regime, the Enterprise Bankruptcy Law (EBL), which became effective on 1 June 2007. This was a welcome development for the world's second-largest economy and one of the largest contributors of world and regional growth.

The step proved to be a timely one with the onset of the global financial crisis the following year – an event that would have a significant impact on China and the rest of the world. In response to the financial crisis, the Chinese government implemented a stimulus plan of approximately US\$576 billion, largely focused on developing infrastructure, which was funded by way of loans from its state banking system.

Although the stimulus plan had a key role in stabilising China's economy and improving public infrastructure, China's debt has become an increasing matter of concern. According to Bank for International Settlements statistics, China's credit-to-GDP ratio increased to 257 per cent in the fourth quarter of 2016, the highest in emerging market economies and similar to the average equivalent ratio for advanced economies (264.5 per cent). This ratio has increased by 41.9 per cent since 2011, the highest increase of any economy.

Although it is very difficult to obtain precise empirical data, the level of non-performing loans in China is thought to be very high. In March 2014, Chaori Co, a private solar energy manufacturer in Shanghai, defaulted on payment of interest in respect of its onshore bonds, which reportedly was the first onshore corporate bond default in China. Since then, onshore bond defaults have been on the rise. As at the end of December 2016, there were reportedly 88 defaults of onshore bonds and, of these, most were by privately held enterprises.

Although the state has stepped in to intervene in some of these cases (eg, *Sinosteel* and *Baoding Tianwei*) it is evident that this is not the norm and the Chinese government increasingly is not willing to bail out troubled businesses. The government has viewed the EBL as an effective tool in allowing insolvent entities to restructure or liquidate. This is also consistent with the government's broader effort since the end of 2015 to reduce industrial overcapacity and to restructure the economy.

In November 2015, the government established five key goals for the Chinese economy:

- to cut excessive industrial capacity;
- to destock property inventory;
- to decrease financial leverage;
- to lower corporate costs; and
- to improve weak links between supply and demand.

In order to cut excessive industrial capacity, the government planned for the liquidation, or preferably, reorganisation of 'zombie companies' (ie, companies that would require bailouts in order to continue to operate, or indebted companies that are able to service interest but not repay their principal debt obligations). These goals were also reflected

in the PRC National People's Congress' 13th Five-Year Plan between 2016 and 2020 on National Economic and Social Development.

The court system responded quickly to the government's efforts. In 2016, the courts concluded 3,602 bankruptcy cases, representing an increase of 60.6 per cent from 2015.

## Key features of the EBL

Prior to the commencement of the EBL, corporate insolvency laws in China consisted of a patchwork of inconsistent laws and local rules and regulations. The EBL was praised for finally giving China a modern bankruptcy law regime that applies to both state-owned enterprises and non-state-owned enterprises.

The EBL provides for three different types of bankruptcy proceedings: reorganisation, reconciliation and liquidation. A case will default to a liquidation case unless the company can be reorganised under the reorganisation proceeding under Chapter 8 of the EBL or settle its debts with its creditors under the reconciliation process under Chapter 9 of the EBL. Reconciliation proceedings have been rare. According to the Information Website of National Bankruptcy Cases, a website maintained by the Supreme Court of China, less than 1 per cent of all current bankruptcy cases involve reconciliation proceedings.

The EBL was influenced by the corporate bankruptcy regimes of the United States and the United Kingdom. It therefore contains many of the typical features that one would expect to find in a sophisticated bankruptcy regime in any developed jurisdiction. Some of the key features are set out below.

### Criteria for filing

A company is eligible for bankruptcy filing if it is presently unable to pay its debts as they fall due and its assets exceed its liabilities, or it otherwise lacks the ability to pay its debts. It is also eligible for reorganisation, but not liquidation, if it is obvious that, in the future, the debtor will become insolvent.

### Stay of proceedings

In general, the EBL provides for an automatic stay with respect to creditor collection activities against the debtor once the court order is issued accepting the bankruptcy filing.

The automatic stay prohibits the commencement of any civil lawsuit related to the debtor except in the court where the bankruptcy case is filed. The stay applies to existing lawsuits and arbitration until an administrator is appointed. The stay also prohibits any enforcement against the debtor's property.

### Appointment of administrator

An administrator is appointed by the court with broad powers to manage the debtor's property and business and to supervise the implementation of the reorganisation plan. In considering the debtor's circumstances, the court appoints the administrator from a list of qualified agencies, including law firms, accounting firms and bankruptcy liquidation firms. The administrator's compensation is

decided by the court based on a sliding scale (set as the maximum compensation) on the amount available to be disbursed to creditors in order to incentivise the administrator to enhance recoveries from the bankrupt estate.

### Priorities of claims

The EBL categorises claims in bankruptcy proceedings in the following order of priority:

- bankruptcy costs and expenses and ‘common benefit debts’;
- secured creditors are paid next to the extent of the property over which they hold a security interest;
- wages and certain employment-related payments;
- social insurance and unpaid taxes; and
- ordinary unsecured claims.

### Voting requirements

Resolutions at creditors’ meetings require approval by more than half the creditors attending the creditors’ meeting whose claims represent more than half of the total amount of unsecured debt. Approval of any reorganisation plan or reconciliation plan requires acceptance by a majority in number of each class of creditors’ voting whose claims represent more than two-thirds of the debts owed to the relevant class of creditors, subject to the approval of the court. Where one or more classes of creditors do not approve the reorganisation plan, the court may still approve the plan if certain conditions are met – in effect a cramdown.

### Cross-border insolvency laws

According to article 5 of the EBL and the Civil Procedure, the court may recognise bankruptcy rulings in other jurisdictions in accordance with any international treaties that China is a party to or the principle of reciprocity. Article 5 also provides that the recognition of foreign bankruptcy rulings should not impair China’s public interests or the ‘legitimate interests of the domestic creditors’. To date, there have not been any implementation measures or Supreme Court interpretations in place to set out a ‘recognition procedure’ for foreign bankruptcies, but it would appear that courts have ample latitude to deny recognition if the government has domestic concerns.

China has not adopted the UNCITRAL Model Law on Cross-Border Insolvency, nor any other treaties relating to cross-border insolvency matters. China has also not ratified the Hague Convention on the Recognition and Enforcement of Foreign Judgments in Civil and Commercial Matters, but has entered into bilateral treaties for civil and commercial cases with more than 30 countries, such as France, Italy, Spain, Mongolia and Russia, but not including the United States or the United Kingdom. In addition, the Supreme Court published a judicial opinion in 2015 which stipulated that for countries in the ‘Belt and Road’ areas that have not concluded bilateral judicial assistance agreements with China, the court may consider offering judicial assistance, notwithstanding the lack of such agreement.

In practice there are few, if any, precedents of the Chinese court recognising foreign bankruptcy cases commenced in jurisdictions that do not have a bilateral treaty with China.

In the Qualified Domestic Institutional Investor (QDII) fund loss suit brought by Hua An Fund Management against Lehman Brothers, the court allowed the bankruptcy trustee of Lehman Brothers to act as its representative in the domestic proceeding, thereby, at least as a practical matter, recognising the status of the foreign bankruptcy trustee’s appointment. However, the recent Korean bankruptcy case of *Hanjin Shipping* is a stark example of the lack of cross-border insolvency laws in China. Hanjin, which was subject to rehabilitation proceedings (and subsequently bankruptcy proceedings) in Korea, did

not apply for recognition of the Korean proceedings in China because the bilateral treaty for civil and commercial cases between China and Korea only covers reciprocal recognition of arbitration decisions but not court judgments. In consequence, several Chinese courts preserved Hanjin’s assets in China for litigation purposes and ruled on breach of contract suits against Hanjin, notwithstanding the stay imposed by the Korean proceedings.

### Room for improvement

Since the EBL became effective in 2007, the number of concluded bankruptcy cases significantly decreased (by 51 per cent), from 4,200 in 2007 to 2,059 in 2014. The case load only started to increase after the government decided to force reorganisation and liquidation of ‘zombie companies’ in late 2015. A number of weaknesses of the EBL and its underlying infrastructure have been identified as possible contributing factors for this decrease.

### More judicial interpretations or implementation measures are needed

After the EBL came into force, the Supreme Court released two judicial interpretations, in 2011 and 2013 respectively, relating to EBL rules. The first interpretation addressed the filing and commencement of a bankruptcy case, and the second dealt with case administration, debtor transactions and other corporate law issues associated with bankruptcy procedures. In addition, supporting measures have been issued by the Supreme Court regarding the administrator and various aspects of bankruptcy infrastructure.

Although the first and second interpretations and special measures clarified important issues (such as case administration, debtor transactions and other corporate law issues associated with the bankruptcy procedure), more judicial interpretations are still required to provide much-needed clarity on various issues, including creditors’ voting mechanisms, distribution procedures, duties of directors and officers, and the appointment and compensation of administrators. The lack of clarification results in unpredictability, inconsistency and delays.

### The role of the government as lessor and creditor in bankruptcy proceedings needs to be clarified

As the government still plays a critical role in the country’s economic activities in both the public and private sectors, the government will often have claims against the bankrupt estate. For example, as the bankrupt entity often has land leased from the government because of China’s land ownership system, restrictive transfer provisions contained in land leases may cause problems in transferring the lease in the bankruptcy process. As unpaid land-transferring fees owed to the government are treated as ordinary unsecured debt, the government sometimes lacks an incentive to cooperate in the bankruptcy proceedings.

Another example is tax. Although unpaid taxes prior to bankruptcy are treated as preferred claims, it is not clear which category taxes (or cancellation of tax benefits) associated with the disposal of the bankrupt company’s assets belong to. The law also does not clearly provide for the priority status of municipal electricity and water claims. For this reason, municipality departments sometimes cut off services to bankrupt companies, which can have an obvious disruptive impact.

### Lack of protection for post-reorganisation companies

Chinese companies are often reluctant to go through the reorganisation process because of anticipated commercial challenges that they will face post-reorganisation. For example, China does not have a credit protection system for reorganised companies. In other words,

companies in some provinces will remain on the official ‘discredited’ company list maintained by the banking system and court systems, and local commerce departments and tax bureaus. Even in provinces that are willing to remove reorganised companies from the ‘discredited’ list, it is not uncommon for companies to be excluded from business dealings by business partners, financial institutions and government agencies because of their prior bankruptcy or reorganisation. Such treatment may defeat many of the goals that bankruptcy is designed to achieve.

Similarly, the current EBL allows for distributions and payments to be made to creditors after the reorganisation process has been completed where claims were filed late. Owing to the lack of transparency and publicity in bankruptcy proceedings, these types of claims, and sometimes even malicious late filings, become a heavy burden for reorganised companies. Issues associated with the government’s role in the proceedings also have a negative effect on the reorganised company. Since the law does not clearly specify which category of claims government imposed fines or penalties belong to, and it allows for post-reorganisation distributions to late claimants, the government often waits until after the reorganisation process is complete to collect fines and penalties.

### Practical issues

Other limitations and weakness have also emerged from the EBL’s application in practice.

- The experience of the courts in bankruptcy matters remains a work in progress and can vary from province to province.
- There is a shortage of experienced administrators with sufficient professional expertise, sophistication and government connections to deal with complicated bankruptcy cases.
- There is still a lack of transparency for creditors and other stakeholders.
- The local government has a strong political interest in major companies, which sometimes leads to a lack of motivation for the government to offer necessary assistance and cooperation in liquidating these companies.

The Chinese government has acknowledged that there is room for improvement. China’s desire to enhance its bankruptcy and reorganisation systems was a topic of discussion in 2016 between Chinese President Xi Jinping and former US President Barack Obama when they met ahead of the G20 summit in China’s eastern city of Hangzhou, during which it was noted that:

*China and the United States recognise the importance of the establishment and improvement of impartial bankruptcy systems and mechanisms. China attaches great importance to resolving excess capacity through the systems and mechanisms relating to mergers and acquisitions; restructuring; and bankruptcy reorganisation, bankruptcy settlement and bankruptcy liquidation, according to its laws. In the process of addressing excess capacity, China is to implement bankruptcy laws by continuing to establish special bankruptcy tribunals, further improving the bankruptcy administrator systems and using modern information tools. China and the United States commit to, starting as early as 2016, conducting regular and ad hoc communication and exchanges regarding the implementation of our respective bankruptcy laws through forums or mutual visits.*

### Recent efforts to improve bankruptcy infrastructure

So far China’s efforts to enhance its bankruptcy regime have been very focused on improving its underlying infrastructure, as opposed

to amending its laws. Some of the key initiatives are outlined in the following paragraphs.

### The establishment of liquidation and bankruptcy courts

In June 2016, the Supreme Court issued its Notice concerning the Plan for Establishing Liquidation and Bankruptcy Trial Divisions in intermediate Courts across China. This provided that the centrally administered municipality designate at least one intermediate court to establish a liquidation and bankruptcy trial court and an intermediate court in each of the capital cities, and further that the para-provincial cities also establish liquidation and bankruptcy trial courts. It also provided that the higher court of provinces should determine whether to establish liquidation and bankruptcy trial courts in intermediate courts in other cities or regions.

As of February 2017, 73 courts across China have set up a liquidation and bankruptcy trial court, including four high courts, 47 intermediate courts and 22 lower courts.

In parallel with the launch of liquidation and bankruptcy trial courts, the Supreme Court issued another supporting measure to improve case management – the Announcement on Adjusting the Classification of Mandatory Liquidation and Bankruptcy Cases (the Announcement). The Announcement creates a separate major case category and assigns a case filing number for liquidation and bankruptcy cases so that these will cease to be part of general civil cases. This should help to streamline the transition of liquidation and bankruptcy cases from the civil courts to the new liquidation and bankruptcy courts.

### The launch of the information website for national bankruptcy cases

China has sought to address concerns about transparency and to modernise its court infrastructure by establishing a website that contains certain factual information relating to enterprise bankruptcy proceedings and debtors, and to streamline certain procedural matters in those proceedings. In August 2016, the Supreme Court officially launched the Information Website for National Bankruptcy Cases (the Website). The Website has three major functions: an information platform for national bankruptcy cases for debtors and creditors; a working platform for bankruptcy judges; and a working platform for bankruptcy administrators.

For any particular case, the Website provides, among other things, corporate and financial information about the debtor, the presiding court of the case and the administrator, as well as court documents relating to the case. It also consolidates statistics in respect of bankruptcy filings in different regions and industrial sectors. Through the Website, the creditor, debtor and related parties can commence a case filing, report a claim, submit an objection and attend creditors’ meetings and vote.

### Transfer of enforcement cases for bankruptcy review

One area of concern for the Chinese government has been the number of civil cases in its court system in which the defendant has insufficient assets to satisfy a successful judgment. According to the Supreme Court, there were 4.8 million enforcement cases in 2015, and in 40 to 50 per cent of these cases, there were allegedly no available assets to enforce against.

As part of the court system’s efforts to resolve this issue, and consistent with China’s crackdown on ‘zombie companies’, in January 2017, the Supreme Court issued the Guiding Opinions on Several Issues concerning the Transfer of Enforcement Cases for Bankruptcy Review (the Guiding Opinions), which established a procedure for enforcement cases to be converted to bankruptcy proceedings.

According to the Guiding Opinions, if the debtor, which must otherwise qualify for the bankruptcy proceeding under the EBL, or any of the claimants in the enforcement proceeding, agree to such conversion, the judge of the enforcement case should transfer the case to the relevant court with bankruptcy jurisdiction.

### Further reforms are required

Although the recent changes are to be welcomed and progress is being made in further enhancing and modernising China's bankruptcy regime, it is submitted that further reforms are required, including the following.

- Given China's size and role in the global economy, it is imperative that China has effective cross-border insolvency laws. China should consider adopting the UNCITRAL Model Law on Cross-border Insolvency, or expanding the list of countries with which it has entered into bilateral treaties.
- Legislative reforms (including amendments to the EBL) or additional judicial interpretations are required to clarify certain procedural and technical matters and create greater predictability and consistency, and fewer delays.
- China does not yet have a personal bankruptcy regime. The introduction of such a regime would be desirable, particularly given the increasing levels of household debt in China.

### Implications for foreign creditors and trends in offshore restructuring

On 12 January 2017, the People's Bank of China issued the Circular of the People's Bank of China on Matters relating to the Macro-prudential Management of Full-covered Cross-border Financing (Circular No. 9), which provides that PRC-incorporated companies may incur cross-border debt in domestic and foreign currencies in accordance with a quota based on a formula relating to their respective capital or net assets multiplied by certain parameters that are issued by the regulator based on macroeconomic factors. Circular No. 9 replaces the former foreign lending regime in which foreign lending to domestic entities was subject to scrutiny by local government. It remains to be seen whether the changes will result in a meaningful increase in foreign creditors lending directly to onshore Chinese companies. If this occurs, the EBL would become very relevant to foreign creditors.

Historically, because of a variety of factors, including restrictions on foreign lending, the financing structure typically used by Chinese groups to raise foreign debt involves a holding company (Holdco) incorporated in a tax efficient jurisdiction such as the Cayman

Islands, with its shares listed on an offshore stock exchange such as the Hong Kong Stock Exchange. The Holdco raises offshore debt in the form of banking facilities, notes or foreign currency-denominated bonds, but holds no assets other than shares in intermediate holding companies or Chinese operating subsidiaries (Opcos). The Opcos conduct the business of the group and own the group's hard assets and business operations. The Opcos will invariably owe substantial debts to onshore creditors, including banks, trade creditors and other unsecured claimants.

Foreign creditors therefore invariably find themselves structurally subordinated to onshore claimants if the group faces financial difficulties. This is particularly challenging when the Opcos are placed in a bankruptcy or reorganisation process under the EBL. This occurred in the 2013 case of Chinese solar group Suntech Power in which certain of its onshore operating subsidiaries were placed into bankruptcy proceedings under the EBL. Suntech, the Cayman Islands incorporated holding company, had issued US\$541 million of bonds to offshore bondholders. In the EBL proceedings relating to the operating subsidiaries, the Suntech group's operations were sold in a court-supervised auction, which resulted in severe losses for both the secured and unsecured creditors.

One lesson learned from the *Suntech* case is that a key to a successful offshore Chinese restructuring is to keep the onshore subsidiaries out of an EBL process. An early and proactive dialogue between the company and all relevant onshore and offshore stakeholders is imperative in this regard.

The recent offshore restructuring of the US\$309 million New York law governed bonds issued by the British Virgin Islands-incorporated and Hong Kong-listed parent of Chinese coal trading group Winsway Enterprises is a good example of a successful Chinese restructuring. Winsway was able to keep its operating subsidiaries out of an EBL process. The bonds were restructured by way of parallel schemes of arrangement in the British Virgin Islands and Hong Kong, with Chapter 15 relief being granted under the US Bankruptcy Code.

The use of parallel schemes of arrangement in relevant offshore jurisdictions has been an emerging trend in restructuring the offshore debts of Chinese groups. Recent similar schemes include LDK Solar, Mongolian Mining and Kaisa. Chapter 11 of the US Bankruptcy Code is also sometimes an option. In LDK Solar, US Chapter 11 proceedings were also used in respect of US-based subsidiary guarantors. The China Fishery group, a Hong Kong-based leader in fishmeal and fish oil production, is currently undergoing restructuring in US Chapter 11 proceedings.



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Naomi Moore is a partner in Akin Gump's Hong Kong office. She focuses her practice on cross-border restructurings, insolvencies and workouts, and financing matters. With the considerable experience she has gained in Asia, Australia and London, Naomi has been involved in a number of complex and high-profile restructurings with a particular focus on solvent and insolvent schemes of arrangement. Naomi has advised on restructurings, distressed situations and finance transactions in China, Hong Kong, Indonesia, India, Korea, Japan, Singapore and Australia. Naomi's recent work includes representing a steering committee of holders of US\$309 million of notes issued by Winsway Enterprises Holdings Limited, an HKSE-listed and BVI-incorporated company with a substantial coal trading and processing business in China; and an ad hoc group of convertible bondholders of PT Bumi Resources, an Indonesian coal company controlled by the Bakrie family in connection with a US\$4 billion restructuring through PKPU proceedings in Indonesia.

Naomi is named as a leading lawyer for restructuring and insolvency by *Chambers Asia*, *IFLR 1000* and *Who's Who Legal*. She is also recommended by *The Legal 500 Asia-Pacific* for restructuring and insolvency.



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The financial restructuring team in Asia – which forms part of a wider global financial restructuring team operating across London, Frankfurt, Hong Kong, New York, Washington DC, Dallas and Los Angeles – has extensive experience representing offshore investors in restructurings, insolvency proceedings and financings. This involves bridging not only different laws and regulatory regimes, but also providing a 24-hour service through its cross-border team. Advising on restructurings for bondholders, noteholders and other creditors of companies in financial distress in a wide variety of sectors – including shipping, energy/oil and gas, financial services, insurance, manufacturing, commodities, technology and telecommunications – the team has played a leading role representing creditors in numerous high-profile workouts and restructurings in the Asia-Pacific region, including most recently, PT Bumi Resources Tbk, Winsway Enterprises Holdings Limited, China Shanshui Cement Group Ltd, Emas Chiyoda Subsea, Suntech, Alinta Energy, Griffin Coal, Toshiba Inc, Elpida Memory, Inc, Spansion and Takefuji.



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