

# CHINA MATTERS

Paul Hastings' Newsletter for Investing & Operating in the People's Republic of China

November 2006

## Opportunities And Risks Under China's New Bankruptcy Regime

### Overview

The Enterprise Bankruptcy Law of the People's Republic of China (the "New Bankruptcy Law"), a major revision of the existing law, was adopted on August 27, 2006 and will take effect on June 1, 2007.

The New Bankruptcy Law brings both opportunities and risks for the entire market, while at the same time transforms China's bankruptcy regime from an administrative or even political process into a judicial process, bringing it closer to the bankruptcy laws of Western nations.

The New Bankruptcy Law is significant in many ways, including:

- **No Prior Government Approval.** Both debtors and creditors can petition local courts directly for bankruptcy without having to seek prior approval from other government agencies (such as the industrial authority in charge of the debtor).
- **Transparency.** Creditors and debtors now have relatively clear guidelines with respect to reorganization, composition and liquidation procedures.
- **Independence.** Courts are allowed to appoint non-government officials, such as accountants and lawyers, as bankruptcy administrators. Court appointments, once made, may also be challenged by creditors, so that a neutral administrator may eventually be appointed.
- **Security Interests.** "Secured" interests are given priority over all other claims.

- **Extraterritoriality.** Foreign bankruptcy decisions may be enforced by Chinese courts, provided certain conditions are satisfied.
- **Liquidity.** More companies are expected to seek bankruptcy protection under the New Bankruptcy Law, which should promote the disposition of assets held by insolvent debtors.

### Discussion

#### Impact on Investors

**Opportunities.** There will likely be an increase in court-ordered asset sales as creditors and insolvent debtors take advantage of the New Bankruptcy Law. The "big four" banks, in particular, may find themselves equipped with a more powerful weapon to dispose of non-performing loans sitting on their books. For investors, this presents an excellent opportunity to acquire assets such as non-performing loans.

Strategic and financial investors will find greater opportunities to buy valuable industrial assets at a discount from underperforming state-owned enterprises. When banks auction off distressed and non-performing mortgages, real estate investors will find more opportunities to bid for properties that can be easily re-positioned in China's fast growing real estate market.

**Risks.** Investors should be aware that under the New Bankruptcy Law, a debtor's existing shareholders may be forced by a bankruptcy administrator to make additional capital contributions even if such contri-

butions are not yet due and are not allowed to receive distribution of profits during reorganization.

## Impact on Creditors

**Stronger Protection.** The New Bankruptcy Law provides stronger protection to creditors in several respects. A creditor can petition a local court directly to force an insolvent debtor into bankruptcy. However, to do this, the creditor is required to show that (i) the debtor is unable to pay its debts when due and (ii) either the value of the debtor's assets is less than its liabilities or the debtor "clearly does not have the ability to repay its debts."

The New Bankruptcy Law also entitles creditors to enforce a foreign bankruptcy decision against a debtor's assets inside China in accordance with bilateral or multilateral treaties or the principle of reciprocity.

**Secured Interests.** The New Bankruptcy Law gives the highest repayment priority to secured interests, higher in priority than bankruptcy fees, wages, social insurance premiums and taxes. Although a reorganization triggers an automatic moratorium that prevents secured creditors from enforcing their secured interests until the reorganization ends, the New Bankruptcy Law nevertheless greatly improves a secured creditor's standing when compared with the existing bankruptcy regime.

**Risks.** The New Bankruptcy Law provides a clearer process for debtors and creditors to work out a voluntary settlement through a composition (involving a voluntary settlement with creditors). It only applies to unsecured debts and is implemented in accordance with a "composition plan" that must be approved by creditors owning at least two-thirds of all unsecured debt and by the court. A composition, however, presents a risk to creditors with smaller unsecured interests who may be forced by other creditors to settle.

Because debtors will find it easier to obtain bankruptcy protection under the New Bankruptcy Law, debtors who are expecting to enter into bankruptcy may be tempted to strip out good assets before the New Bankruptcy Law takes effect on June 1, 2007. To protect creditors' interest from such actions, an administrator has the right under the New Bankruptcy Law to petition local courts to void any unfair transfer, transaction, creation of security interests, or cancellation of debts carried out by the insolvent debtor in the one-year period before the court accepts the bankruptcy petition.

## Impact on Debtors

**Opportunities.** Debtors will have greater access to the reorganization process. An automatic moratorium prevents creditors from enforcing claims during reorganization, which can be up to twelve months. The moratorium gives debtors some "breathing room" from creditors while they try to revive their businesses.

In addition, debtors may find the composition process appealing because the process allows a voluntary settlement with creditors instead of an involuntary process imposed by a court. Since a composition results in a settlement rather than an official bankruptcy, it may also help debtors avoid the usual stigma of having been declared "bankrupt."

If a reorganization or composition (involving a voluntary settlement with creditors) fails, then liquidation will take place and all the debtor's assets will be sold by way of public auction, unless otherwise decided by the creditors.

**Risks.** Easier access to involuntary bankruptcy for creditors means that a debtor facing a "cash crunch" may be forced into bankruptcy by nervous or hostile creditors. Although a court has the discretion to accept or reject such a petition from creditors, the New Bankruptcy Law is unclear about the criteria a court would use in exercising the discretion.

## Highlights of the New Bankruptcy Law

### • Scope

Generally, the New Bankruptcy Law applies to all enterprise legal persons incorporated in China, including foreign-invested enterprises ("FIEs"), state-owned enterprises ("SOEs") and private domestically-owned companies. The central government announced in January 2006 that it will exclude over two thousand SOEs that are most in danger of going bankrupt under the New Bankruptcy Law. If any of these businesses enter into a bankruptcy, wages, social security insurance, and other employee benefits will continue to have a higher priority over secured debts and other liabilities. Partnerships and sole proprietorships generally are not subject to the New Bankruptcy Law, but they must follow its provisions on liquidation.

### • Filing

No prior approval from other government agencies is required before a bankruptcy petition is filed with a court. Both creditors and debtors are entitled to petition for a liquidation or a reorganization. The debtor may also petition for a composition.

### • Administrator

The court is responsible for appointing an administrator, who has broad authorities, including the power to manage the debtor's assets during the bankruptcy. In a departure from the existing law, the administrator can be chosen from outside the government, including among accountants and lawyers.

### • Reorganization

Debtors, creditors, or investors who own more than a 10% interest in a debtor may apply directly to a court for reorganization. If a reorganization is granted, an automatic moratorium prevents all security interests from being enforced. A reorganization may be converted into a liquidation if the business further deteriorates.

### • Priorities

The New Bankruptcy Law gives secured claims the highest priority. The order of priorities is as follows: (1) secured claims; (2) bankruptcy expenses; (3) wages, pension benefits and premiums for medical insurance; (4) overdue payments to social security funds and taxes; and (5) unsecured claims.

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For further information, please contact:

#### Beijing

David Livdahl: [davidlivdahl@paulhastings.com](mailto:davidlivdahl@paulhastings.com)

#### Hong Kong

Maurice Hoo: [mauricehoo@paulhastings.com](mailto:mauricehoo@paulhastings.com)

Raymond Li: [raymondli@paulhastings.com](mailto:raymondli@paulhastings.com)

#### Shanghai

Toshiyuki Arai: [toshiyukiarai@paulhastings.com](mailto:toshiyukiarai@paulhastings.com)

Mitch Dudek: [mitchdudek@paulhastings.com](mailto:mitchdudek@paulhastings.com)

David Wang: [davidwang@paulhastings.com](mailto:davidwang@paulhastings.com)

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