

China

Nicholas Howson, Lester Ross and Donald Clarke

Paul Weiss Rifkind Wharton & Garrison

1 LEGISLATION

What legislation is applicable to bankruptcies and reorganisation?

The mere notion of bankruptcy, liquidation or reorganisation of industrial enterprises was long considered anathema in the People's Republic of China (PRC or China), and directly contrary to the underlying logic of a centrally planned, state-owned economy and industrial system. The state's reluctance to allow bankruptcies was rooted in the ideology of the governing Communist Party but also reflects fiscal constraints with respect to payments to unemployed workers and the recapitalisation of state-owned commercial banks forced to write off loans as bad debts. However, such notions have gained wider acceptance concurrent with:

- China's ongoing transformation to a socialist market economy;
- reform of the 'state-owned enterprise' (SOE) system;
- corporatisation and the gradual removal of the state from control and ownership of enterprises; and
- the requirement that industrial enterprises survive as independent economic entities without government allocations of capital.

This acceptance initially found expression in 1986, with the promulgation of China's only formal bankruptcy statute, the **Law of the PRC on Enterprise Bankruptcy – For Trial Implementation** (Bankruptcy Law), which became effective on 1 November 1988, three months after its necessary complement, the **Law on Industrial Enterprises Owned by the Whole People** ('the SOE law'), a law regarding the entity addressed by the Bankruptcy Law – SOEs ('enterprises owned by the whole people' or *quanminsuoyouzhi qiye*) – became effective on 1 August 1988.

An important elaboration of the Bankruptcy Law is the **Supreme People's Court Opinion on Questions Regarding the Bankruptcy Law** (Bankruptcy Law Opinion), issued on 7 November 1991. However, because the Bankruptcy Law, by its terms, applies only to SOEs, the **Civil Procedure Law of the PRC** (Civil Procedure Law), effective on 9 April 1991, includes a chapter (XIX, Articles 199-206) addressing the bankruptcy of 'enterprise legal persons' (*qiye faren*) that are not SOEs. The bankruptcy provisions of the Civil Procedure Law are extremely brief and, as a consequence, the **Supreme People's Court Opinion on Certain Issues in the Application of the Civil Procedure Law** (the Civil Procedure Law Opinion) issued on 14 July 1992 seeks to make the more detailed provisions of the

Bankruptcy Law applicable to bankruptcy proceedings covered by the Civil Procedure Law by incorporating 'relevant provisions' of the Bankruptcy Law by reference. Unfortunately, it is not clear which provisions of the Bankruptcy Law govern bankruptcies of non-SOE enterprise legal persons under the Civil Procedure Law.

The Supreme People's Court has also issued a notice and a set of regulations with respect to the conduct of bankruptcy proceedings: the **Urgent Notice on the Earnest Prevention by the People's Courts of Debtors Evading Debts in Enterprise Bankruptcy and Restructuring Proceedings** (the Urgent Notice), issued on 10 August 2001, and the **Regulations Concerning Certain Issues in the Hearing of Enterprise Bankruptcy Proceedings** (the Hearing Regulations), issued on 30 July 2002. The Hearing Regulations apply to all bankruptcies, whether under the Bankruptcy Law or the Civil Procedure Law.

Two Notices issued by China's State Council have a significant impact on the implementation of SOE bankruptcy, and are reflected in the terms of the Draft Bankruptcy Law (defined below):

- the **Notice on Issues Concerning the Trial Implementation in Several Cities of SOE Bankruptcy** (the 1994 Notice) of 24 October 1994, and
- the **Supplementary Notice on Issues Concerning Trial Implementation in Several Cities of SOE Bankruptcy and Merger and Re-employment of Staff and Workers** (the 1997 Notice) of 2 March 1997.

Approval of bankruptcy petitions by financial institutions (bank and non-bank) by the relevant government regulatory department is required under the **1994 Provisions on the Administration of Financial Institutions** (the Financial Institutions Provisions) and, with respect to banks, insurance companies and financial leasing companies respectively, under the **Commercial Banking Law of the PRC** effective on 1 July 1995, the **Insurance Law of the PRC** effective on 1 October 1995, and the **Financial Leasing Companies Administrative Measures** effective on 30 June 2000. The closure and liquidation of financial institutions under the supervision of the People's Bank of China, ie commercial banks and trust and investment companies, is governed by the **Rules on the Closure of Financial Institutions** effective on 15 December 2001.

In 1996, China promulgated special procedures for the (voluntary) liquidation of foreign invested enterprise legal persons (FIEs), the **Rules on the Liquidation of FIEs** (FIE

Liquidation Rules), which apply to FIEs that have not been declared insolvent. The **Company Law of the PRC** ('the Company Law'), effective on 1 July 1999, contains certain provisions on company ('limited liability company' and 'company limited by shares') liquidations; the Company Law, the **Securities Law of the PRC** (Securities Law) which became effective on 1 October 1999, and related enactments set out the basis for directors' and officers' and supervisors' responsibilities with respect to bankruptcies; and the **Security Law of the PRC** (Security Law), effective on 1 October 1995, sets out the basic rights and priorities of secured creditors. Some provincial and municipal governments have promulgated regulations regarding enterprise bankruptcy, which presumably must not violate the Bankruptcy Law, the Bankruptcy Law Opinion, the Civil Procedure Law, or the Civil Procedure Law Opinion. Although not yet enacted, a draft of an amended Bankruptcy Law (Draft Bankruptcy Law) has been formulated, and may see approval and promulgation in the future (see 30 below).

2 EXCLUDED ENTITIES

What entities are excluded from bankruptcy proceedings and what legislation applies to them?

As described above, the Bankruptcy Law applies by its terms only to SOEs, to the exclusion of all other entities.

Bankruptcies of other enterprise legal persons (but not all legal or natural persons) – including FIEs – are governed by the Civil Procedure Law, the Civil Procedure Opinion, and, as noted above, 'relevant' provisions of the Bankruptcy Law. Bankruptcies of financial institutions are covered by the Financial Institutions Provisions, rules on the Closure of Financial Institutions and legislation governing the specific type of financial institution. The Bankruptcy Law is apparently not applicable to bankruptcies of financial institutions, and the Draft Bankruptcy Law would expressly exempt commercial banks from its reach. The Draft Bankruptcy Law would expand the reach of bankruptcy proceedings to all enterprise legal persons, partnerships, sole proprietorships, and other economic organisations established in accordance with law. Voluntary liquidations of non-insolvent FIEs are covered by the FIE Liquidation Rules.

3 SECURED LENDING AND CREDIT (IMMOVABLES)

What are the principal types of security devices (eg mortgages etc) that are taken on immovable (real) property?

Security interests are governed by the Security Law. Security on immovable (real) property is taken by a mortgage on state-owned land use rights and attachments to the land subject to the land use rights owned by the mortgagor.

A mortgage may be taken on land use rights 'granted' by the state to a rights-holder or the latter's transferee, in consideration of payment of a land use rights grant fee, ie granted land use rights, and the attachments to the land subject to the land use rights owned by the mortgagor. A mortgage may also be taken on wasteland that is leased (by the state or a local collective) to a party for management in accordance with specified ecological requirements. The mortgage must be in writing and must include certain provisions required under the Security Law, although other provisions may also be included in the mortgage contract. All

mortgage contracts are required to be recorded with the relevant local government department, generally the land management or real estate bureau, within 15 days after signature of the contract.

The following rights may not be mortgaged:

- rights to collectively-owned land;
- private plots;
- educational, medical and other public welfare facilities;
- land use rights that are in dispute;
- land which is subject to legal supervision and other real property that is subject to legal restrictions; and
- other property subject to other prohibitions on mortgage.

The 1997 Notice importantly provides that the payment of resettlement expenses for SOE workers displaced by the SOE's bankruptcy has priority over even the secured party with respect to mortgaged land use rights. (This same priority with respect to SOEs is included in the Draft Bankruptcy Law.)

4 SECURED LENDING AND CREDIT (MOVEABLES)

What are the principal types of security devices (eg mortgages, etc) that are taken on movable (personal) property?

The Security Law also governs security on movables (personal property). Security may be taken by a mortgage on machinery, means of communication and transportation and other property owned by the mortgagor, or such property if state-owned, provided that the mortgagor has the right of disposition under law. All mortgage contracts must be in writing and include the provisions required under the Security Law. They are required to be recorded with the local industry and commerce administration bureau within 15 days of completion of the transaction. Security on movables may also be taken by a pledge. Pledges may also be used to take security on rights including:

- bills of exchange;
- cheques;
- promissory notes;
- bonds;
- certificates of deposit;
- warehouse receipts;
- bills of lading;
- transferable shares and share certificates;
- transferable trademarks, patents and copyrights;
- other rights eligible to be pledged under the law.

All pledge contracts must be in writing and include the provisions required under the Security Law. A pledgee bears civil liability to the pledgor if the pledged property is lost or damaged due to improper care while in its custody.

Although the Security Law does not clearly stipulate that a security interest can be taken in an uncertificated equity interest in an entity such as a Sino-foreign equity joint venture, such interests have been recognised by courts and enforced against the grantor. As such interests are not capable of being held in the custody of the grantee of the security interest and the rules on notice are not clear, it is uncertain how courts may dispose of competing claims among multiple holders of a security interest in the same equity interest.

5 UNSECURED CREDIT

What remedies are available to unsecured creditors (eg seizures, attachments, judgment, etc)?
Are the processes difficult or time-consuming? Are pre-judgment attachments available? Do any special procedures apply to foreign creditors?

Unsecured creditors enjoy no such remedies but are entitled to become members of the creditors' meeting formed by the People's Court in a bankruptcy proceeding, as discussed in 19 below. Such creditors may also petition a People's Court for an order preserving assets under the Civil Procedure Law.

6 COURTS

What court(s) are involved in the bankruptcy process? Are there restrictions on the matters that the court(s) can deal with?

China does not have special bankruptcy courts. Bankruptcy proceedings are heard by a collegiate panel of the People's Court where the debtor's principal business structure is located or, if the debtor does not have such a structure, where it is registered to do business. Whether the proceedings are conducted by the basic-level or higher-level People's Court is determined initially by the level of the government department which approved and registered the establishment of the debtor. However, a higher-level People's Court may assert jurisdiction over a proceeding to be held by a lower-level People's Court or assign a proceeding over which it has jurisdiction to a lower-level People's Court, and a lower-level People's Court may request that a proceeding within its jurisdiction be removed to a higher-level People's Court, under Article 39 of the Civil Procedure Law. Proceedings for debtors subject to the state plan are heard by the intermediate-level People's Court. Adjustments may also be made with respect to proceedings involving certain provincial-level enterprises with special circumstances, subject to approval by the People's Court at the next higher level. However, the Draft Bankruptcy Law would provide that all bankruptcy proceedings be held at the intermediate-level or higher-level People's Court. The Draft Bankruptcy Law would also allow SOEs established prior to the effective date of the Company Law, ie 1 July 1994, to be made subject to special regulations with respect to specific issues.

7 VOLUNTARY LIQUIDATIONS

What are the requirements for a debtor to commence a voluntary liquidation of its business?
What are the effects of the commencement of the liquidation?

Under the Bankruptcy Law, a SOE debtor requires the consent of its superior or supervisory department (department in charge) to petition the People's Court for a declaration of bankruptcy. Petitions for other debtors are submitted by their promoters or shareholders' committee. Under the Hearing Regulations, the debtor's petition must include:

- a written bankruptcy application;
- evidence of the debtor's status;
- name of the entity's legal representative and list of principal responsible persons;
- personnel situation and placement plan;
- an explanation of the circumstances regarding the debtor's losses, with schedules;
- a detailed schedule of the circumstances involving the debtor's assets through the date of bankruptcy, including tangible and intangible assets and investments;

- details of the debtor's accounts in financial institutions;
- schedule of the debtor's credits;
- schedule of the debtor's debts;
- guarantees relating to the debts;
- ongoing litigation; and
- such other materials as may be required by the People's Court.

The Bankruptcy Law requires that the People's Court conduct an investigation and determine whether to accept the case within seven days of receipt, unless it requires amended or supplementary materials. The Supreme People's Court in the Urgent Notice and the Hearing Regulations required that People's Courts hearing bankruptcy and reorganisation cases make debtors supplement their materials or reject the bankruptcy petitions upon discovering that the debtor is evading its debts or that the value of the debtor's assets exceeds the value of its debts. The People's Court also may revoke its acceptance of a bankruptcy petition if the debtor cannot explain where its assets have gone or if assets have been 'stripped'.

The People's Court notifies known creditors within 10 days of receipt of the debtor's detailed list of debts. Acceptance of the bankruptcy case by the People's Court results in a stay of execution of civil procedures relating to the debtor's assets and a prohibition of partial repayments by the debtor to creditors, except as required for the debtor's normal operations and production. Notice is provided promptly by the People's Court to the debtor's bank to prohibit the handling of settlements for repayment by the debtor of its debts. The debtor will be liquidated by order of the People's Court if the debtor's department in charge does not apply for reorganisation. Voluntary liquidations of non-insolvent FIEs are covered by the FIE Liquidation Rules, which require approval by the department which approved the establishment of the FIE.

8 INVOLUNTARY LIQUIDATIONS

What are the requirements for creditors to successfully place a debtor in involuntary liquidation?
What are the effects of the commencement of the liquidation?

Under the Hearing Regulations, the creditor's petition must include:

- the facts describing the origin of the debt with supporting evidence;
- the nature and amount of the debt, and whether or not there is a guaranty, with supporting evidence; and
- evidence that the debtor cannot settle its debts when due.

The People's Court may allow the debtor to object to the creditor's petition. If the debtor's objection to the creditor's rights is found to have merit by the People's Court, the creditor's petition will not be accepted and the creditor will instead be directed to file suit. The creditor's petition also will not be accepted if the People's Court finds that the petition damages the debtor's commercial reputation for purposes of unfair competition.

Even though a creditor is entitled to petition for the bankruptcy of an insolvent SOE, a SOE debtor may not be placed in liquidation unless:

- the debtor's department in charge does not submit a reorganisation plan or a reconciliation agreement is not agreed with the creditors' meeting or is not implemented;

- the debtors' financial situation continues to deteriorate, and the creditors' meeting applies for termination of the reorganisation proceedings;
- the period for reorganisation has expired; or
- the debtor engages in the concealment or illegal transfer of its assets.

Involuntary liquidations of FIEs are subject to the provisions on special liquidations under the FIE Liquidation Rules, which require approval of an application that may be submitted by the FIE's investors or creditors to the department which approved the establishment of the FIE.

9 VOLUNTARY REORGANISATIONS

What are the requirements for a debtor to commence a financial reorganisation? What are the effects of the commencement of the reorganisation?

A SOE debtor may not commence reorganisation of any type. Under the Bankruptcy Law, the department in charge of a debtor subject to an involuntary bankruptcy petition may apply to the People's Court to conduct a reorganisation within three months of the acceptance of the case by the People's Court. Such reorganisation must be completed within two years and will be directed by the debtor's department in charge. The application for reorganisation is then submitted to the creditors' meeting, specifying the period within which the debtor will repay its obligations.

The bankruptcy proceedings are stayed by the People's Court if the debtor and its creditors reach a reconciliation agreement. Importantly, the representatives of the debtor's employees also have a statutory right to notice by the People's Court and an opportunity to express opinions on the proposed reorganisation. Such notice also includes an order to protect the debtor's assets and to prevent illegal dispositions or transfers of the same. The Civil Procedure Opinion provides for voluntary reorganisation with respect to entities other than SOEs.

10 INVOLUNTARY REORGANISATIONS

What are the requirements for creditors to commence an involuntary reorganisation? What are the effects of the commencement of the reorganisation?

There is no provision for an 'involuntary reorganisation' under the Bankruptcy Law or the Civil Procedure Law. Under the Bankruptcy Law, the department in charge of a SOE debtor subject to an involuntary bankruptcy petition may apply to the People's Court to conduct a reorganisation of the debtor within three months of the acceptance of the case by the People's Court (see 9 above).

11 DOING BUSINESS IN REORGANISATIONS

Under what conditions can the debtor carry on business during a reorganisation? What conditions apply to the use of assets and to creditors who supply goods or services after the filing? What are the roles of the creditors and the court in supervising the debtor's business activities?

The debtor may continue to carry on its business during a reorganisation so long as it does not make settlements with creditors except as required for its normal operations and production. During the reorganisation period, the department in charge of the debtor is to make periodic reports to creditors and the People's Court.

12 SALE OF ASSETS

In (a) a reorganisation or (b) a liquidation, what provisions apply to (1) the sale of specific assets out of the ordinary course of business and to (2) the sale of the entire business of the debtor?

As stated in 23 below, the liquidation committee may apply to the People's Court to recover assets sold outside the ordinary scope of business within six months prior to the commencement of bankruptcy proceedings. The Hearing Regulations provide that auction shall be the preferred method for disposition of bankruptcy assets, and that complete sets of equipment generally shall be sold as sets.

13 STAYS OF PROCEEDINGS/MORATORIA

What prohibitions against the continuation of legal proceedings or the enforcement of claims by secured and unsecured creditors are imposed by legislation or court order in (a) liquidations and (b) reorganisations? In what circumstances can secured or unsecured creditors obtain relief from such prohibitions?

Upon docketing of a bankruptcy case by a People's Court, enforcement proceedings of all kinds against the debtor are to be stayed, and then come under the jurisdiction of the People's Court hearing the bankruptcy case. This appears to include proceedings by secured creditors.

There are no provisions giving unsecured creditors relief from a stay. Secured creditors may petition the People's Court handling the bankruptcy for enforcement of their security interest.

14 SET-OFF AND NETTING

To what extent are creditors able to exercise rights of set-off or netting in a liquidation or in a reorganisation? Can creditors be deprived of the right of set-off either temporarily or permanently?

Banks enjoy rights of set-off unless prohibited by contract, and may actively enforce their rights as creditors in bankruptcy proceedings and must cooperate with debtors in reorganisation proceedings by restructuring loans, under the **Guidance Opinions on Strengthening Collection and Clearing of Bad Assets**, issued on 15 June 2000. The Bankruptcy Opinion stipulates that creditor banks may not take funds from the debtor's bank account in satisfaction of the debt, and a 1995 Supreme People's Court document states that an investor in a Chinese-foreign joint venture company may not set off amounts owed to it by the company against what it owes the company in the form of unpaid registered capital contributions.

15 POST-FILING CREDIT

Does your country's insolvency system allow a debtor in (a) a liquidation or (b) a reorganisation to obtain secured or unsecured loans or credit? What priority is given to such loans or credit?

Nothing in bankruptcy law specifically prohibits a debtor in liquidation or reorganisation from obtaining secured or unsecured credit. However, a loan would be subject to the same rules governing the debtor's operations generally; in the case of a liquidation, for example, a loan must be in furtherance of the liquidation proceedings. Furthermore, applicants for commercial loans must satisfy the lender's debt-equity ratio requirements.

16 SUCCESSFUL REORGANISATIONS

What features are mandatory in a reorganisation plan? How are creditors classified for purposes of a plan and how is the plan approved?

Under the Bankruptcy Law and Civil Procedure Law, a successful reorganisation is based on a reconciliation agreement reached between the debtor and the creditors' meeting providing for the repayment of the debtor's debts. Approval of such an agreement requires an affirmative vote of a majority of the creditors, who must hold at least two-thirds of the amount in value of unsecured claims. Secured creditors have priority with respect to the assets in which they have taken security but have no vote in the approval of a reconciliation agreement unless they waive their priority rights. Reorganisation of a SOE under the Bankruptcy Law is directed by its department in charge and must be completed within two years. The opinions of the debtor's employees are also solicited.

17 EXPEDITED REORGANISATIONS

Do procedures exist for expedited reorganisations (eg 'prepackaged' reorganisations)?

There are no procedures for expedited reorganisations. However, the Hearing Regulations (and the Draft Bankruptcy Law) provide for an expedited reconciliation procedure.

18 UNSUCCESSFUL REORGANISATIONS

How is a proposed reorganisation defeated and what is the effect of the plan not being approved? What happens if there is default by the debtor in performing an approved plan?

A proposed reorganisation is defeated if it fails to receive the affirmative vote of a majority of the creditors in the creditors' meeting who must hold at least two-thirds of the amount in value. Default by the debtor as a result of the voidable transactions listed in 21 below will result in termination of the reorganisation process and a declaration of bankruptcy by the People's Court if the interests of the creditors have been seriously impaired.

19 BANKRUPTCY PROCESSES

During a bankruptcy case, what notices are given to creditors? What meetings are held? What committees are or can be formed? What powers or responsibilities do these committees have? Can creditors initiate proceedings to pursue remedies against third parties?

Public announcements are made within 10 days of the People's Court's acceptance of a bankruptcy case. Known creditors are given notice within 10 days of the receipt by the People's Court of a detailed list of debts submitted by the debtor. The public announcement must stipulate the date of the first creditors' meeting. Creditors are given either seven or 20 days' notice of creditors' meetings (depending upon where the meetings are located). Where a debtor is a guarantor of another party, it must inform the creditor of the guaranteed party within five days of receipt of notice that the People's Court has accepted the bankruptcy proceeding. The first creditors' meeting is held within 15 days of the expiration of the claim declaration period. Later meetings are convened when necessary by:

- the People's Court;
- the creditors' meeting chairman;
- a liquidation committee established by the People's Court; or
- creditors whose combined holdings are at least 25 per cent of the unsecured claims.

Creditors are not authorised to initiate proceedings to pursue remedies against third parties or to alter remedies in the administration of the case.

The People's Court under the Hearing Regulations may form an enterprise supervisory group when the debtor's management cannot fulfil its responsibilities. Such supervisory group will consist of representatives from the department in charge or the shareholders' committee, enterprise management and major creditors, and also may include accountants and lawyers. The functions of the enterprise supervisory committee are to:

- inventory and protect the debtor's assets;
- confirm the debtor's debts;
- conduct essential business activities that are in the debtor's interest;
- make necessary payments upon authorisation by the People's Court; and
- such other tasks as may be authorised by the People's Court.

The enterprise supervisory group is dissolved upon formation of a liquidation committee.

20 CLAIMS AND APPEALS

How is a creditor's claim submitted and what are the applicable time limits? How are claims disallowed and how does a creditor appeal a disallowance? Are there any provisions that deal with the purchase, sale or transfer of claims against the debtor?

Creditors have one month to file a claim if they received notification of the bankruptcy proceedings (and three months of the public announcement if they did not receive notification). According to the Bankruptcy Law Opinion, creditors are not authorised to appeal rulings of the People's Court except for rulings rejecting bankruptcy petitions. A party objecting to a ruling may apply for review to the People's Court that issued the ruling, and may appeal a rejection of a bankruptcy petition or a bankruptcy declaration to the People's Court at the next higher level within 10 days after issuance of the ruling. The People's Court at the next higher level is required under the Urgent Notice to supervise the court hearing the case, and order corrections or even issue interlocutory orders when necessary to correct errors. A creditor challenging the legality of a resolution of a creditors' meeting may seek an order from the People's Court within seven days of adoption of the resolution.

21 PRIORITY CLAIMS

What are the major (a) governmental and (b) non-governmental privileged and priority claims in liquidations and reorganisations? Which priority and privileged claims have priority over secured creditors?

Secured interests are generally excluded from the assets of the debtor available for distribution. However, according to the 1997 Notice (which applies only to SOEs), the first priority in bankruptcy in 111 designated cities belongs to workers (the priority of workers outside these cities is unclear). This priority covers resettlement expenses of workers of a bankrupt enterprise. These expenses are funded from the disposition of land use rights, even if such rights are mortgaged for the benefit of creditors. If such revenues are insufficient, revenues from unencumbered property and then from other encumbered property are used. The next priority belongs to holders of security interests. Expenses of the

bankruptcy proceeding are next. Included in this latter category, again for 111 designated cities, are living expenses of workers according to the 1997 Notice. The effect of such provision is to put such 'living expenses' ahead of all unsecured creditor claims, which are paid only when administrative expenses have been settled. Next are employee wages and labour insurance costs and then taxes owed by the bankrupt. Unsecured creditor claims are last.

22 DISTRIBUTIONS

How and when are distributions made to creditors in liquidations and reorganisations?

The People's Courts handling bankruptcy cases are required under the Urgent Notice to earnestly supervise and guide the liquidation committee to protect to the maximum extent the lawful interests of creditors and other parties and prevent misappropriation of state assets. There are no specific rules governing the timing of distributions, except that they must be completed before the bankruptcy proceeding is terminated by the People's Court.

23 VOIDABLE TRANSACTIONS

What types of transactions can be annulled or set aside in bankruptcies and what are the grounds? What is the result of a transaction being annulled?

The Bankruptcy Law provides that five types of action will give the liquidation committee established by the People's Court the right to apply to the People's Court to recover property, if such actions occur within six months prior to the commencement of the bankruptcy proceedings:

- concealment, illicit distribution, or gratuitous transfer of assets;
- sale of assets for less than their value;
- furnishing of security to previously unsecured creditors;
- advance discharge of unmatured obligations; and
- renunciation of the debtor's own claims against others.

Repayment of debts outside of a debtor's normal operations and production and other similar actions by a debtor in bankruptcy are also void. Repayments must be made in accordance with specified procedures.

24 DIRECTORS AND OFFICERS

Do corporate officers and directors have personal liabilities for any pre-bankruptcy actions or for particular types of claims? Can they be subject to other sanctions for other reasons?

The Bankruptcy Law provides for disciplinary sanctions (imposed perhaps by the Ministry of Supervision, although the law is not clear) for the legal representative of a SOE, or the leaders of a SOE's department in charge, if such person or department is determined to bear the major responsibility for the bankrupt's condition. In cases where such a person or department neglects its duties and the consequent bankruptcy causes serious losses to state assets, criminal liability may be assessed (a prison sentence, or forced labour for up to five years).

The Bankruptcy Law also provides criminal sanctions for legal representatives and parties directly responsible for preferential transfers within six months prior to a bankruptcy application, as described in 23 above. Criminal liability is governed by the **Criminal Law of the PRC**, amended on 14 March 1997, which provides that an entity's responsible

persons may face liability for false reporting of assets during liquidation or preferential transfers of assets causing serious damage to creditors or other persons. Likewise, the **General Principles of the Civil Law of the PRC**, effective on 1 January 1987, provide for civil and, in cases of a criminal law violation, criminal liability of the legal representative of an entity which disposes of its assets following dissolution, cancellation or a declaration of bankruptcy.

Notwithstanding certain deficiencies in the corporate legal structure being formulated in China (ie doubts regarding the existence of fiduciary duty under the Company Law, or a private right of action by shareholders under the Company Law and the Securities Law), there are duties and liabilities for directors and officers of Chinese companies limited by shares and limited liability companies under the Company Law, Securities Law and related enactments, including liability for resolutions of the board which violate law and/or the articles of association, and cause serious losses to the company in question (unless the director in question is recorded in the company's minutes as objecting to the resolution). There is some uncertainty as to whether such duties and liabilities are applicable to directors and officers of FIEs established under separate and prior legislation for such FIEs. Directors and officers of Chinese companies limited by shares which list stock overseas (which includes the Hong Kong Special Administrative Region) may have additional duties and liabilities pursuant to specific statutes governing such entities, or mandated articles of association which such issuers must adopt.

25 CREDITORS ENFORCEMENT

Are there processes by which a business can be liquidated outside of the bankruptcy process (eg seizure by a creditor)? Outside of court proceedings? How are these processes carried out and what are the consequences?

Neither the Bankruptcy Law nor any other statute provides for such procedures.

26 CORPORATE PROCEDURES

Are there corporate procedures for the liquidation or dissolution of a corporation? How do such processes contrast with bankruptcy proceedings?

The Bankruptcy Law only makes provision for SOEs to petition for a declaration of bankruptcy (with the approval of its department in charge) or a creditor of a bankrupt SOE to lodge an application for its bankruptcy with the People's Court of competent jurisdiction.

The Company Law allows (at Chapter VIII) for a company to form a liquidation committee to carry out liquidation:

- if its term of operation expires;
- if there is any other basis for dissolution permitted in its articles of association;
- if its shareholders vote for such dissolution; or
- because of merger or division.

(This is in addition to the allowance for formation of a liquidation committee in the event a company is declared insolvent according to law, ie according to the bankruptcy statute.)

Such liquidation committee is formed by shareholders (limited liability companies) or a group determined by the

Update and trends

Bankruptcy law in China continues to focus on the closing of SOEs and the prevention of urban worker unrest as well as the protection of creditors. The Urgent Notice and Hearing Regulations provide broader rights to appeal rulings of the People's Courts and also direct the People's Courts to expedite bankruptcy proceedings and tighten controls on fraudulent transfers and illegal evasion of debts by debtors. The People's Courts handling bankruptcy cases are required under the Urgent Notice to earnestly supervise and guide the liquidation committees to protect to the extent possible the lawful interests of creditors and other parties and prevent misappropriation of state assets. However, as noted in question 21, even creditors' rights granted by national legislation can be overridden by administrative notices and other nominally subordinate regulations aimed at providing extra payments (relative to what the Bankruptcy Law and Civil Procedure Law already provide) to laid-off workers.

The Hearing Regulations continue this trend. Damages from rescinded labour contracts with regular employees are granted equal status with unpaid wages, ahead of taxes and general unsecured debt. Similarly upgraded are claims for

'labour compensation' by irregular and temporary employees; presumably their unpaid wages were formerly treated as general unsecured debt because of their lower status. Top priority is also given to 'raised funds' (*jizi kuan*) from staff and workers; this term probably refers to funds extracted coercively or semi-coercively from employees.

The Hearing Regulations also further weaken creditor rights by removing certain assets from the bankruptcy estate. Not only is enterprise housing previously transferred to employees under a housing reform programme excluded from the estate, but housing not yet transferred is to be made available, if feasible, to the employees at a bargain price instead of becoming part of the bankruptcy estate.

The net effect of this elevation of employee claims is the reduction of assets available to general unsecured creditors; but the government's chief priority at the moment, higher even than the fiscal health of the banking system, is the avoidance of urban worker unrest. The various judicial and administrative amendments to the Bankruptcy Law and section on bankruptcy in the Civil Procedure Law all appear to have as their main purpose the progressive transfer of wealth from creditors to employees.

shareholders in general meeting (companies limited by shares). In certain circumstances, the People's Court can be petitioned to manage the liquidation process on behalf of a voluntarily liquidating company. The FIE Liquidation Rules apply to the voluntary liquidation or dissolution of FIEs (while specifically ceding administration over bankrupt or insolvent FIEs to the bankruptcy statute).

27 CONCLUSION OF CASE

How are liquidation and reorganisation cases formally concluded?

Reorganisations of a debtor are formally concluded when:

- an enterprise is able to discharge its liabilities in accordance with a reconciliation agreement;
- the People's Court declares the enterprise bankrupt because it is unable to discharge its liabilities by the end of the reorganisation period; or
- any of the following occur:
 - non-implementation of the reconciliation agreement;
 - continuing deterioration of the financial condition that leads to the creditors requesting the end of reorganisation; or
 - any of the voidable transactions listed in 23 above.

When the distribution has been completed, the liquidation group applies to the People's Court to terminate the bankruptcy proceedings. The proceedings end when the Court grants such application, which should occur within seven days of the application.

28 UNCITRAL MODEL LAW

Is the adoption of the UNCITRAL Model Law on Cross-Border Insolvency under consideration in your country? If so, what is the present status of this consideration?

Adoption of the UNCITRAL Model Law is not under consideration.

29 INTERNATIONAL CASES

What recognition or relief is available concerning an insolvency proceeding in another country?

How are foreign creditors dealt with in liquidations and reorganisations? Are foreign judgments or orders recognised and in what circumstances? Is your country a signatory to a treaty on international insolvency or on the recognition of foreign judgments?

There are no special procedures under current PRC statutes for multi-country bankruptcies. There are no special provisions for foreign creditors. The current multi-country Asia Pulp & Paper proceedings provide a major learning experience for China's courts and government.

Foreign debt (including guarantees) of domestic enterprises (except as provided below) must be approved and then registered, within 15 days of entry into the applicable loan agreement, with China's foreign exchange control authority, the State Administration of Foreign Exchange (SAFE) or its local level branch. Foreign debt for this purpose includes debt owed to foreign financial institutions located within China (ie foreign bank branches). In contrast, borrowings of FIEs need not be approved but generally must be registered with SAFE. Registration of debt of these enterprises is usually a formality, although tightening of foreign exchange rules has made registration, as a practical matter, more onerous. Short-term debt, such as trade financing of 90 days or less, generally falls

outside the approval and registration requirements. Foreign debt that is required to be approved and/or registered may be unenforceable if not so approved and/or registered. Unenforceability is merely an extension of the general principle of PRC law that any agreement lacking a government approval stipulated in law is not an effective contract.

Foreign civil judgments are recognised by the People's Courts on the basis either of a treaty or reciprocity. In practice, reciprocity has been interpreted to mean the existence of a treaty. China is not a signatory to any multinational treaties on international insolvency or the recognition of foreign judgements.

30 PENDING LEGISLATION

Is there any new or pending legislation affecting domestic bankruptcy procedures, international bankruptcy cooperation or recognition of foreign judgments and orders?

The Draft Bankruptcy Law has been revised several times and remains under active discussion, but has yet to make it onto the National People's Congress legislative agenda for formal passage and promulgation. The Draft Bankruptcy Law constitutes a substantial revision of the Bankruptcy Law, with 10 Chapters and 160 Articles (compared with six Chapters and 48 Articles in the Bankruptcy Law). While attempting to provide a comprehensive and modern basis for China's bankruptcy procedures, it is distinguished from the statute currently in effect by its:

- wider application to debtors including individual proprietorships and their investors, and to assets of the debtor outside the PRC provided that there is a treaty or reciprocal relationship between the PRC and the jurisdiction where the assets are located and certain other conditions are met;
- appointment by the court of an administrator such as a lawyer or accountant to administer the debtor's assets and business under supervision of the People's Court and the creditors' meeting or supervisor appointed by the creditors' meeting;
- 12-month rescission period for fraudulent transfers and six-month rescission period for preferential transfers;
- inclusion of fuller court-supervised reorganisation provisions (not to exceed 12 months);
- allowance for consensual workouts;
- fuller rights of appeal by participants (creditors and debtors); and
- fast-track conciliation procedure.

Among the major issues in the revision of the Bankruptcy Law are the disposition of assets of bankrupt SOEs and the extent to which the Bankruptcy Law should include social welfare provisions for workers of bankrupt enterprises above and beyond, for example, their claims as creditors for back wages. Disagreements over such issues continue to delay enactment.

Paul, Weiss, Rifkind, Wharton & Garrison

American and International Lawyers

Beijing

Tel: +8610 65056822

e-mail: nhowson@paulweiss.com

lross@paulweiss.com

dclarke@paulweiss.com

New York

Tel: +1 212 373 3000

e-mail: akornberg@paulweiss.com

jsaferstein@paulweiss.com

Hong Kong

(Hong Kong Solicitors
and International Lawyers)

Tel: +852 2536 9933

e-mail: fkinmonth@paulweiss.com

jlange@paulweiss.com

Other offices Tokyo, Washington, Paris, London