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Solving the Insolvency Puzzle

China's new bankruptcy law could bring the country's legal framework closer to international norms—if it is implemented effectively

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After 12 years of debate and deliberation, China adopted the long-awaited PRC Enterprise Bankruptcy Law (EBL) in August 2006. The new law, which took effect on June 1, 2007 and replaced the previous insolvency laws, represents, at least on paper, a major advance in China's insolvency law framework. As with any new national insolvency law, however, especially in emerging markets, the key to success lies in implementation. It will also be important to see how the gaps and ambiguities in the new law—of which there are several—are addressed.

Overview of the new law

In emerging markets, a modern insolvency law can give parties greater confidence in the legal framework that underlies lending and investment decisions, including decisions by foreign investors whether to invest in a particular jurisdiction. These lending and investment decisions in turn are important factors that can affect a nation's prospects for economic growth and development. Moreover, in an economic system such as China's, where state-owned enterprises (SOEs) have been important players, a modern insolvency law may provide a valuable tool for resolving situations of financial

distress in a more commercial manner as well as a potential means of addressing SOE reform.

Briefly stated, China's new law incorporates a number of features of a modern insolvency law found in the international standards set by organizations such as the World Bank and the United Nations Commission on International Trade Law (UNCITRAL). Among other major elements, the EBL features the possibility that enterprises in financial distress may be subject to court-supervised reorganization. (The new law also provides for the liquidation of insolvent enterprises and a procedure known as "conciliation.") In contrast, previous PRC laws on the subject appeared to emphasize liquidation, and prior Chinese government practice, especially pursuant to government policies adopted in the mid-1990s, encouraged the resolution of financial problems facing SOEs by various additional means, such as mergers, spinoffs, and asset sales.

The new law essentially introduces a two-part test, both parts of which must apparently be satisfied, for determining whether a debtor is eligible to commence an insolvency proceeding: a liquidity or cash flow test (an inability to pay debts as they fall due) and a balance sheet test (the amount of liabilities exceed the value of assets). The new law also incorporates the notion of an "involuntary" insolvency filing where a creditor may initiate an insolvency proceeding against the debtor. In such a case, only the liquidity or cash flow test for insolvency must be satisfied. Broadly speaking, these new standards under the EBL for commencing an insolvency case rely on concepts that are familiar in the international insolvency world, but the EBL's requirement that a voluntary insolvency filing satisfy both tests, as opposed to only one, is a more stringent requirement than the recommendations found, for example, in the UNCITRAL *Legislative Guide on Insolvency Law*. Of course, it will be important to see how the PRC courts apply the commencement criteria set forth in the EBL and whether the need to satisfy a two-part test for commencement of voluntary cases serves as a barrier to insolvency filings by debtors.

Other major changes include the following:

Unified treatment of SOEs and non-SOEs

The EBL, which applies to all "enterprise legal persons" provides for unified treatment of SOEs and non-SOEs, including private enterprises and foreign-invested enterprises (FIEs). This contrasts with the previous bifurcated structure in which SOEs were subject to the 1986 PRC Enterprise Bankruptcy Law (for Trial Implementation) and non-SOEs were subject to Chapter 19 of the 1991 PRC Civil Procedure Law. (The situation was further complicated by the existence of other significant regulations, decrees, and interpretations on insolvency matters.) Significantly, the new law also permits SOEs to file for insolvency without first obtaining the permission of their supervising government department, which was a requirement under the old law.

Despite the new law's promise of unified treatment of SOEs and non-SOEs, the PRC government has exempted roughly 2,100 financially distressed SOEs from the application of the new law until the end of 2008. During this period, the insolvencies of these exempted SOEs will proceed according to the "policy bankruptcy" framework, under which insolvencies are administered by the government and State Council regulations essentially outline how to address the financial issues facing insolvent SOEs. Under these regulations, workers effectively enjoy priority rights to the proceeds from the sale of "land use rights," which were to be used to pay for the resettlement of displaced employees and certain other employee benefits, despite the fact that the previous insolvency laws would have granted priority to claims of secured creditors over employee claims.

Ranking of claims

During the debate surrounding the new insolvency law, the ranking of claims, particularly how secured claims would rank vis-à-vis employee claims, remained a major point of contention until the new law was finally adopted. Under the EBL, secured claims take priority over employee claims, which in turn rank ahead of unsecured claims. Nonetheless, the new law "grandfathers" certain types of employee claims that arose before the new law was adopted in August 2006 and gives those claims priority over secured claims.

Bankruptcy administrator

The new law also establishes the position of bankruptcy administrator, which is vested with a wide range of significant responsibilities, including taking over the assets of the debtor, deciding the internal management of the debtor, and managing and disposing of the debtor's assets. The new law provides that the role of the administrator may be filled by a professional services firm, such as a law firm or an accounting firm, which could enhance the professionalism of the position and bring necessary expertise to bear. The new law is silent on whether the administrator must be Chinese, and it therefore remains to be seen whether foreign professional service firms will be permitted to fill that role. According to the new law, PRC courts will appoint administrators and determine their remuneration, and in April 2007 the Supreme People's Court issued two detailed pronouncements intended to provide guidance to

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the courts on these matters. (Among other matters, one of the pronouncements deals with conflicts of interest.)

Some observers note that a strong administrator may create an important counterweight to the role of People's Court judges in insolvency proceedings. Despite the administrator's importance, the EBL allows for the possibility of what is essentially a modified "debtor in possession" approach whereby the debtor may apply to the court for a court order that permits the debtor to remain in charge of its own assets and business operations as long as the debtor remains under the supervision of the administrator.

Reorganization mechanism

Several important features of the new law are meant to support an effective reorganization mechanism. For example, the EBL calls for the convening of a creditors' meeting and the related creation of a creditors' committee, which is given broad powers to, among other things, "supervise the management and disposal of the debtor's assets." The law also requires the debtor or bankruptcy administrator to explain to the creditors' committee any matter within its scope of responsibilities. Furthermore, the new law provides a time-bound procedure for reorganization and a limited "cram-down" for obtaining approval of a reorganization plan over the objection of dissenting creditors.

Preservation of insolvency estate and post-commencement finance

The new law contains other provisions that are designed to help preserve or reconstitute the assets of the debtor's insolvency estate. As with such provisions in any nation's insolvency regime, these provisions can increase the possibility of a successful reorganization, but they can also be helpful if a liquidation becomes necessary. Specifically, the new law incorporates provisions that permit the administrator to "avoid" or invalidate transactions that, in the parlance of bankruptcy law, would be referred to as avoidable preferences and fraudulent transactions. The new law also provides for a stay of certain types of enforcement and other actions against the debtor. (The stay does not take effect until the court has accepted a bankruptcy application. This creates a gap period between filing and acceptance during which the debtor is potentially exposed to enforcement and other actions.) Any civil actions or arbitration involving the debtor may resume after the administrator takes over the debtor's assets. In addition, the new law provides for the rejection or assumption of what are generally referred to as "executory contracts" or what the EBL defines as a "contract that has been established before the acceptance [of the bankruptcy application] yet has not been fully performed by both parties concerned."

Moreover, in a brief discussion, the new law alludes to the possibility of post-commencement finance (known in the United States as "debtor-in-possession" financing), which can be critical in determining the success of a reorganization attempt since the availability of such finance can give the

debtor some breathing space and allow it to continue to operate as a going concern. Since the concept of post-commencement finance is described in minimal detail in the new law, it may be unlikely that post-commencement finance will become a serious financing option in China until the relevant legal framework is much more fully developed.

Implementation

Although it is difficult to predict with any certainty how the EBL will be implemented, several factors could affect its implementation, including: employee claim and labor issues, the role of SOEs, the role of the courts, the role of asset management companies (AMCs) and other nonperforming loan (NPL) holders, and the role of foreign banks.

Employee claim and labor issues

In insolvency proceedings, employees' interests can be adversely affected in several ways, including through layoffs and wage concessions. During a liquidation, even more so than in a reorganization, these issues can come into sharp relief because only a limited amount of money is available to distribute for payment of all of the outstanding claims according to the priority scheme established under the relevant insolvency law.

In China, whether the courts and relevant government authorities will permit labor interests to be adversely affected by a neutral application of the EBL is an open question. As noted above, the EBL generally ranks employee claims below secured creditor claims, but whether the courts and relevant government authorities will respect this ranking in cases where it would cause undue dislocation to employees of an insolvent enterprise remains to be seen.

In short, the new law may be tested if the interests of labor and social stability conflict with a strict application of the ranking of claims provided for in the new law. The manner in which the PRC courts and government authorities deal with this issue may depend in part on what type of social safety net exists to protect the interests of displaced workers. If the courts believe that the social safety net provides sufficient protection for displaced workers, they may be more willing to strictly apply the ranking of claims as set forth in the new law.

SOEs

Given their precarious financial situation, many SOEs should be prime candidates for having their financial situations addressed under the EBL as opposed to the "policy bankruptcy" framework. It is unclear what will happen to the roughly 2,100 SOEs that have been exempted from the EBL until the end of 2008 if their financial situations are not fully addressed by the end of that period. For example, would the government extend the exemption? In addition, given the large number of SOEs that have been exempted from the EBL for the time being, it is unclear how many SOEs will actually have their financial situations addressed under the new law. Finally, for SOEs dealt with under the new law, it

remains to be seen how much protection local governments and courts will extend to SOEs that are important at the local level and whether doctrines such as “too big to fail” will be invoked to shield certain large SOEs from the effects of the new law.

The role of courts

As with any new law, China’s EBL may only be as good as the courts that administer it. In this respect, the EBL may face some serious challenges. For one thing, not many Chinese judges, particularly outside of the large cities, have had significant experience handling insolvency matters. Insolvency law is a fairly technical and complex area of the law that requires, among other things, a sound understanding of commercial matters. The implementation of the EBL could be hindered if the judges charged with enforcing it are not specialists, or at least conversant, in insolvency law or other complex commercial matters. Thus, judges across China will likely need training in basic principles of insolvency law as well as in the specific details of the EBL.

Furthermore, since the EBL has several ambiguities and gaps, courts applying it may see themselves as having considerable latitude in how they interpret the law, which could lead to the inconsistent application and interpretation of the new law. Judges might also use ambiguities in the EBL as a pretext for developing interpretations that may be inconsistent with the law’s underlying purpose and philosophy.

As in many emerging market jurisdictions, PRC courts also face concerns about independence, corruption, and transparency. For example, allegations of corruption concerning several bankruptcy judges in the Shenzhen Special Economic Zone came to light last fall. Moreover, the PRC courts, whose judges are appointed by government officials, are not viewed as being entirely immune from governmental and political pressures.

The role of AMCs and other NPL holders

PRC banks and AMCs, which were originally created to take over the NPLs of the four largest state-owned banks, have a large stock of NPLs on their books. The exact magnitude of the NPL problem has been a matter of considerable controversy in recent years. Some foreign observers have estimated that the stock of NPLs could amount to hundreds of billions of dollars, whereas the PRC government has provided significantly lower estimates. Moreover, some foreign observers believe that a significant batch of new NPLs could result from the lending activities of Chinese banks in recent



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years, especially in the real estate sector.

A key question will be whether holders of NPLs—PRC banks, AMCs, or outside purchasers of NPL portfolios—will regard the EBL as an effective mechanism for resolving the financial difficulties of insolvent debtors and for achieving decent debt recovery rates. If NPL holders perceive the new law to be a useful mechanism for addressing the situation of insolvent debtors, they may be willing to use it as part of an overall debt recovery strategy for the

NPLs they hold. Of course, given the time and legal costs involved in pursuing an insolvency proceeding, NPL holders may well consider using remedies under the EBL only in certain well-defined circumstances.

In sum, NPL holders may use the new insolvency process and develop a vested interest in seeing that the new law works effectively and efficiently, particularly with respect to protecting creditor interests. Moreover, even if the holders of NPLs do not regularly resort to the EBL, they may still benefit from the law if they can use it as a credible threat against their underlying debtors to bring debtors to the bargaining table to negotiate an acceptable out-of-court restructuring plan.

The role of foreign banks

Foreign banks and financial institutions have taken minority stakes in a range of PRC banks. In some emerging markets, particularly where foreign banks have acquired a majority stake in domestic banks, the entry of foreign banks has, in the view of some observers, led to greater discipline in domestic banking systems with respect to the handling of NPLs and related debt recovery activities. In this view, foreign banks may be less hesitant to take aggressive action against borrowers, such as opening involuntary insolvency cases against debtors, than their domestic counterparts. In certain cases, domestic banks may be reluctant to upset close pre-existing relationships with local borrowers and their controlling shareholders by aggressively pursuing debt recovery.

Currently, foreign banks in China may not be in a position to significantly shape the debt recovery activities of domestic banks, particularly since foreign investors have been limited to minority stakes in PRC banks. Yet, if China were to open its banking sector more fully, foreign banks and financial institutions might acquire more influence and possibly develop a vested interest in seeing that the EBL protects, or at least is not prejudicial to, the interests of creditors.

Areas of interest to foreign parties

Two important areas related to the new law are of special interest to foreign parties: how cross-border insolvencies are handled and how foreign creditors are treated in comparison to domestic creditors.

Handling of cross-border insolvencies

The UNCITRAL Model Law on Cross-Border Insolvency effectively sets the international standard for addressing cross-border insolvencies in a nation's domestic insolvency legislation. The UNCITRAL Model Law, which has been adopted by more than a dozen nations, including the United States, provides a general framework for courts of one nation to recognize and cooperate with courts overseeing insolvency proceedings in another nation.

Although the EBL is intended to have extraterritorial effect, meaning that PRC proceedings are intended to apply to a debtor's assets located outside of China, the new law takes a narrower view with respect to inbound insolvency proceedings. Specifically, it does not incorporate the UNCITRAL Model Law but instead relies on principles of reciprocity and the existence of treaties with foreign nations in deciding whether to recognize a foreign insolvency proceeding. Moreover, the new law contains a further limitation that an order issued in a foreign proceeding must "not violate the basic principles of the laws of the People's Republic of China, ...not damage the sovereignty, safety or social public interests of the state, ...[or] damage the legitimate rights and interests of the debtors within the territory of the People's Republic of China...."

As a practical matter, the EBL's requirements and limitations pertaining to cross-border insolvency may present serious obstacles to the ability of PRC courts to enforce orders of foreign insolvency proceedings, at least in the near term. The EBL's provisions on cross-border insolvency may not lead to the recognition of foreign proceedings for some time because "China has not entered into any relevant treaties or reciprocal relations on this topic," and does not even have a bilateral agreement with Hong Kong on this issue, according to a 2005 article in the *Columbia Journal of Asian Law* by Professor Charles Booth of the University of Hawaii Law School.

The failure of the new PRC insolvency law to incorporate the UNCITRAL Model Law may create some uncertainty with respect to multi-jurisdictional insolvencies that include China. For instance, it could affect situations where the offshore non-Chinese parent or other affiliate of an FIE in China is involved in a foreign insolvency proceeding outside of China that requires the cooperation of a PRC court to handle assets or other matters in China.

In addition, with the overseas expansion of Chinese corporations and the establishment of offshore corporate affiliates in Hong Kong and other jurisdictions, any insol-

veny proceedings outside of China involving such corporations could also require cooperation and involvement by the PRC courts. The new law's failure to incorporate the UNCITRAL Model Law, however, may make this cooperation more difficult to obtain.

Treatment of foreign creditors

The UNCITRAL *Legislative Guide on Insolvency Law* recommends that a nation's insolvency law "should specify that all similarly ranked creditors, regardless of *whether they are domestic or foreign creditors*, are to be treated equally with respect to the submission and processing of their claims" (emphasis added). The EBL does not specifically address how the claims of foreign creditors will be handled vis-à-vis the claims of domestic creditors.

Thus, although foreign creditors might welcome some of the potential improvements in the overall insolvency framework brought about by the EBL, they may have to wait to see whether they will receive equal treatment vis-à-vis similarly situated domestic creditors under the new law and whether PRC authorities issue any clarifications or other implementing measures that address this issue.

A work in progress

The EBL will likely be a work in progress for some time, and it may be difficult to render any definitive judgment on its efficacy until a meaningful number of cases have been addressed under the new law. A series of implementing regulations and decrees will almost certainly be issued in the coming months. The question will be whether any of these set major new policy directions for the law's implementation. In addition, it may be instructive to observe whether government authorities and other parties in China view the EBL as a help or a hindrance in the transition of the Chinese economy, especially with respect to SOE reform. Moreover, as courts begin to apply the law, interested parties should also observe how the implementation of the new law compares with its letter and spirit.

Observers may also wish to assess how the new law fits into the overall Chinese political economy. In particular, they may wish to know how the courts and government authorities will balance the drive for economic modernization, which could favor a strict application of the new law, with the desire to maintain social stability, which could favor a more flexible application of the new law.

Finally, the new law may have arrived at a propitious moment, given the concern in certain circles that parts of China's economy may be at some risk of overheating, particularly in sectors such as real estate. If there were to be a downturn or correction in the Chinese economy, the new law could be put to the test, which would provide a clear and concrete indication of how it will be implemented. 完