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The New Chinese Bankruptcy Law

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Introduction

On August 27, 2006, after more than ten years of drafting, China's National People's Congress passed the New Chinese Bankruptcy Law ("NCBL"), which is scheduled to become effective on June 1, 2007.

China's existing system of multi-layered bankruptcy statutes, regulations and rulings has been widely criticized as inadequate for dealing with its increasingly market-based economy. Notably, the backbone of China's current bankruptcy system, the Enterprise Bankruptcy Law of 1986 (the "1986 Law"), applies only to state-owned enterprises ("SOEs") and heavily favors liquidation over reorganization. Although the Civil Procedure Law and the Company Law of 1994 complement the 1986 Law, the existing bankruptcy framework suffers from many gaps and omissions.[1] The use of judicial interpretations of the Supreme Court, various specialized policy decrees extending coverage to non-state-owned enterprises ("non-SOEs"), and local rules and regulations to fill these gaps has resulted in a messy and inconsistently enforced legal framework that has impaired foreign investment. Moreover, the current laws mandate that employees' wage and insurance claims receive priority over those of secured creditors.[2]

The NCBL modernizes China's laws to address these concerns. It applies to both SOEs and non-SOEs, shifts the focus away from liquidation towards reorganization, establishes the priority treatment of secured creditors, and incorporates other important concepts from Western bankruptcy law. Although some concerns remain regarding how the NCBL will be applied, it promises to provide investors and creditors with more certainty and confidence as to their ability to recover on invested capital and claims in the event of a bankruptcy filing, and therefore is likely to encourage increased foreign investment in China.

Key Features of the New Chinese Bankruptcy Law

Voluntary or Involuntary Bankruptcy: Similar to U.S. bankruptcy law, the NCBL provides for both a voluntary filing by a debtor as well as an involuntary filing by a debtor's creditors.[3] Unlike U.S. law, however, the NCBL imposes an insolvency requirement for voluntary filings: only a debtor that meets both the balance sheet insolvency test (total liabilities exceeding total assets) and the equitable insolvency test (being unable to pay debts as they come due) is eligible for filing.[4] Nevertheless, the NCBL represents a leap forward from the 1986 Law, which focused on the debtor management's culpability by requiring some form of "mismanagement" as a prerequisite to filing.[5]

Reorganization, Liquidation, Conciliation: One of the key improvements of the NCBL is that it no longer unduly favors liquidation. Under the new law a debtor in a voluntary case may select among three filing options: (i) reorganization under Chapter VIII, which provides for the restructuring of debts,[6] (ii) liquidation under Chapter X, which provides for the termination of operations as well as the sale and distribution of the debtor's assets

under a specific priority framework,[7] or (iii) "conciliation" under Chapter IX, which provides for a streamlined reorganization of unsecured claims, while leaving the rights of secured creditors unaffected.[8] Moreover, even in an involuntary case, creditors are now given the choice between seeking the debtor's liquidation and reorganization.[9]

Court Appointed Administrator: Another important feature of the NCBL is that once the court has accepted the bankruptcy filing, the court will appoint an administrator to take over the debtor's property and manage its affairs.[10] While there is no provision for a debtor-in-possession, a debtor may request the court to permit it to continue to manage the debtor's property under the supervision of the administrator.[11] The NCBL, however, does not specify whether management returns once the debtor has reorganized.

The NCBL does not itself specify who will be eligible to serve as administrator. It only provides that the Chinese Supreme Court will determine eligibility as well as compensation at a later point.[12] It seems unlikely, however, that foreign professionals would be appointed as administrators.

Creditors Meeting: The NCBL also introduces the concept of a creditors meeting. These meetings are somewhat similar to the concept of a creditors' committee under U.S. bankruptcy law. Every creditor becomes a member of such a meeting after it has declared its credits (i.e. asserted a claim) prior to the court specified bar date (a process similar to filing a proof of claim under U.S. bankruptcy law).[13] The role of the creditors meeting is to verify declared credits (i.e., claims), oversee the administrator's performance, determine whether the debtor's business should be continued or terminated, and vote on a proposed plan of reorganization or liquidation or a conciliation agreement.[14]

In addition, the creditors meeting may establish a creditors' committee, consisting of not more than nine creditor representatives, one of whom must be a representative of the debtor's employees.[15] The creditors' committee is charged with supervising the management, distribution and disposal of the debtor's property, as well as other functions authorized at the creditors' meeting.[16] Overall, however, it should be noted that the language of the NCBL does not provide much guidance as to the precise division of labor between the creditors meeting and the creditors' committee.

Employee Claims: The most radical changes to China's new bankruptcy law relate to the treatment of employee claims. Under the current law, employee claims receive priority over secured creditors: if unencumbered assets fail to cover employee claims, the employee claims are paid out of secured creditors' collateral. Under the NCBL, however, all employee claims that were incurred after August 27, 2006 will no longer receive such priority.[17] It is unclear whether the new rule will also apply to SOEs, as the NCBL seems to broadly grandfather pre-reform regulations regarding "special matters" pertaining to SOE bankruptcies.[18]

Other Conforming Changes

The NCBL has adopted many other concepts familiar to Western bankruptcy law including the automatic stay, adequate protection, avoidance powers, assumption and rejection of executory contracts, administrative expense classifications, class voting, cram down, and plan submission.

Automatic Stay: The NCBL provides for an automatic stay that is less sweeping in scope than under U.S. law. In particular, once the court accepts the bankruptcy filing, the new law stays any attachment on or any enforcement procedures against the debtor's property as well as any civil litigation against the debtor.[19] Civil litigation may be resumed, however, once the administrator takes over the debtor's property.[20] It is noteworthy that the automatic stay does not take effect immediately upon filing, but only upon court acceptance of such filing, leaving a gap period during which creditors may continue to seek to collect against the debtor.

Adequate Protection: The NCBL also recognizes, in principle, that a secured creditor may need some form of protection where its collateral may decrease in value during the period of reorganization, but does not elaborate much on the precise manner in which such protection would be provided.[21]

Power to Avoid Certain Transactions: Similar to Western bankruptcy regimes, the NCBL provides for the avoidance of certain transactions. Under Article 32, the administrator can avoid debt payments by the debtor (i) made during the six months before acceptance of the bankruptcy case, and (ii) made while the debtor insolvent (as defined in Article 2), unless the specific payment benefited the bankrupt company's property.[22] Under Article 31, the administrator can avoid fraudulent conveyances made within one year prior to the court's acceptance of the bankruptcy case where the debtor received no or unreasonable consideration.[23] The administrator also has the power to avoid transactions involving actual fraud.[24]

Executory Contracts: The NCBL also permits an administrator to assume or reject executory contracts.[25] In particular, the administrator must assume or reject a contract and notify the counterparty within the earlier of (i) two months after the bankruptcy filing has been accepted or (ii) 30 days after the counterparty has demanded performance, or the contract will be deemed rejected.[26] In addition, the counterparty may request "security" from the administrator in connection with the assumption of the contract, a concept somewhat similar to adequate assurance of future performance under U.S. law.[27]

Administrative Expenses: The NCBL accords priority for various administrative expenses to encourage entities to do business with the debtor after the filing of the case. The administrative expenses are divided into two classes: (i) "expenses for bankruptcy," including litigation costs related to the bankruptcy case, expenses related to the management, valuation, and distribution of the debtor's property, as well as expenses incurred by the administrator;[28] and (ii) "debts of common benefit," which notably include employee wages, social insurance fees and other debts incurred to continue operations.[29] Both classes of claims are to be paid as they come due,[30] and both have priority over prepetition claims; if the debtor has insufficient assets to satisfy both, the expenses for bankruptcy take priority over the debts for common benefit.[31]

Class Voting: The NCBL has adopted many concepts familiar to U.S. bankruptcy law for reorganizing a company, including classification and voting rights for creditors. Pursuant to Articles 82 and 86, adoption of a plan of reorganization requires the approval of the following four classes of creditors: secured

creditors, employees, tax creditors and ordinary creditors.[32] The plan must receive the approval of more than half of the number of creditors in each class present at the meeting and more than 2/3 of the total amount of claims in each class.[33]

Cram Down: The NCBL also permits a court to approve a plan of reorganization over a dissenting class of creditors through a cram down mechanism.[34] A cram down may be used where (i) secured creditors, employees and tax creditors are either unimpaired or have voted in favor of the plan, (ii) ordinary creditors receive at least as much as they would under a liquidation, (iii) equity holders have been treated fairly or voted to approve the plan, (iv) members of the same voting class are treated fairly and equally, and (v) the debtor's business plan is feasible.[35]

Plan Submission: The NCBL requires the debtor or administrator to submit a draft plan within six months after the court has accepted the case.[36] The court may extend this period for an additional three months upon a showing of good cause.[37] If the debtor fails to submit a plan in a timely fashion, then reorganization is terminated and the debtor declared bankrupt.[38] Unlike under U.S. law, however, there is no provision for the submission of competing plans by creditors or shareholders.

Conclusion

While the NCBL constitutes a significant leap forward in the modernization of China's bankruptcy law, it does not address certain core bankruptcy concepts in detail such as the availability of post-petition financing or adequate protection for secured creditors.[39] It remains to be seen whether the new law will be consistently applied and whether there will be adequately trained judges, administrators and other professionals to implement and administer the new law. It also remains to be determined who will be eligible to serve as an administrator and how such a person will in fact be selected.

Nevertheless, the comprehensive extension in coverage beyond SOEs, a shift in focus towards reorganization, the priority treatment of secured creditors and the adoption of numerous concepts from Western bankruptcy law under the NCBL are expected to facilitate the restructuring of distressed companies and thereby contribute to the long-term growth of China's economy.

With over 25 years of experience as a leader in complicated cross-border bankruptcies and restructurings and with an established presence in China through our Beijing and Hong Kong offices, Cleary Gottlieb is ideally situated to advise and assist investors, creditors, and other parties in interest expanding their businesses in the new Chinese bankruptcy landscape.

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1 *See* Charles Booth, *Drafting Bankruptcy Laws in Socialist Market Economies: Recent Developments in China and Vietnam*, 18 Colum. J. Asian L. 93, 99 (Fall, 2004).

2 *Id.* at 139.

3 New Chinese Bankruptcy Law, art. 7. It should be noted that the NCBL does not specify the number of creditors required to file an involuntary bankruptcy.

4 *Id.* art. 2. To be eligible for a voluntary filing, the debtor must be "unable to pay off the debts due, and its assets are

insufficient to pay off all its debts or it obviously lacks the capability to repay its debts." It is noteworthy that Article 2 also permits a voluntary filing if there is an "obvious possibility that [the debtor] will lose the capability to repay its debts." *Id.* There is no guidance on what would constitute such an "obvious possibility." On the other hand, an involuntary filing under the NCBL requires only equitable insolvency, i.e. the "debtor is unable to pay off the debts due". *Id.* art. 7.

5 *See* Enterprise Bankruptcy Law of 1986, art. 2.

6 *See* New Chinese Bankruptcy Law, ch. VII.

7 *See id*. ch. X.

8 *See id*. ch. IX.

9 *See id*. art. 7.

10 *See id*. ch. III.

11 *See id*. art. 73.

12 *See id.* art. 22.

13 *See id.* art. 59. Much like filing a proof of claim under the U.S. law, the new Chinese law requires creditors to declare their credits prior to a bar date set by the court. The bar date may be no less than 30 days and no more than three months after the court has publicly announced the acceptance of the case. Exempted from the need to file such a proof of claim are claims for employee wages, medical and disability benefits, workers' compensation, mandatory social insurance fees and statutory severance fees.

14 *See id.* art. 61.

15 *See id.* art. 67.

16 *See id.* art. 68.

17 *See id*. art. 132.

18 *See id*. art. 133.

19 *See id*, arts. 19-21, 75.

20 *See id*, art. 20.

21 It only provides that where there is "the possibility that the collateral may be damaged or its value may be obviously decreased in such way that they will hurt the rights of the guarantor, the guarantor shall be entitled to ask the People's Court for resumption of exercising the collateral rights." *Id.* art. 75.

22 *See id*. art. 32.

23 *See id*. art. 31.

24 *See id*. art. 33.

25 *See id*. art. 18.

26 *See id.*

27 *See id.*

28 *See id*. art. 41.

29 *See id*. art. 42.

30 *See id*. art. 43, which provides that "[t]he bankruptcy expenses and the common interest debts shall be paid off from time to time out of the debtor's properties."

31 *See id.*

32 *See id*. art. 82. The court may in its discretion establish sub-groups.

33 *See id.* art. 84.

34 *See id*, art. 87.

35 *See id.*

36 *See id*, art. 79.

37 *See id.*

38 *See id.*

39 The new Chinese law does not deal with post-petition financing in much detail, and only provides that "during the period of reorganization, where for the purpose of raising a loan in order to go on with business operations, the debtor or administrator may establish guaranty of the credits." *Id.* art. 75.