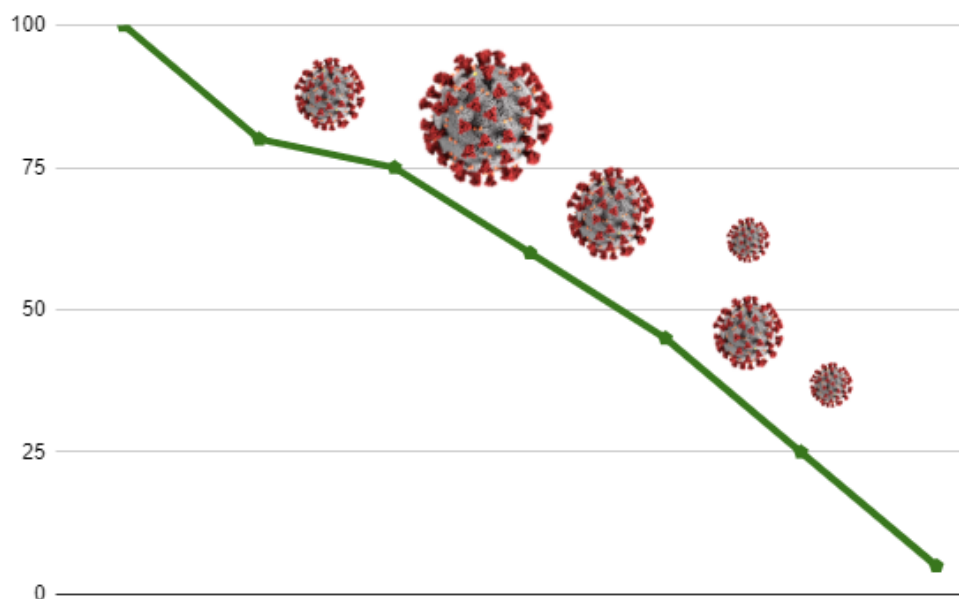


Bankruptcy in China Amid the COVID-19 Pandemic



by: Felix ENGELHARDT, Jackie YANG



1. Introduction

Taking off in late January 2020 as a series of events that first seemed to be an issue of a single nation's concern, COVID-19 has ultimately crossed borders and become a global pandemic of unprecedented scope. Although the situation is gradually improving in China as the numbers of new infections and deaths are reportedly slowly but steadily decreasing, the actual medium- and long term disaster has yet to come: the far-reaching economic ramifications entailed by the virus. Supportive measures are being rolled out in China by governments on all levels to mitigate the negative effects of the outbreak, especially on SMEs. Nonetheless, these measures will either not reach many companies who urgently need them or be insufficient to help them get over this crisis in enough economic health to continue their business as usual. Consequently, numerous companies will have to face an inconvenient but unavoidable truth: going into insolvency.

This article aims at shedding some light on how bankruptcy is handled under the Enterprise Bankruptcy Law of the People's Republic of China (in the following: "PRC Bankruptcy Law" or "the law") and at highlighting what affected companies should bear in mind under these exceptional circumstances.

2. Main Features of Bankruptcy in China

Initially established in 1986 to help ailing state-owned enterprises find a safe exit into liquidation, the PRC Bankruptcy Law in its current form is the result of a major makeover in 2007, judicial interpretations, and guiding opinions. Under the current system, bankruptcy law now applies to all sorts of entities legally established in China that possess an independent legal personality, no matter if they are owned by the state or private persons, including individual proprietorship enterprises. It does not (yet) apply to private individuals, which is one of the main weaknesses of China's bankruptcy system. However, there is some movement in this field which will be dealt with more in detail later in this article.

The numbers of bankruptcy cases accepted and closed by PRC courts indicate the system is being used more in recent years: according to a statement issued by China's Supreme People's Court in March 2018, the number of bankruptcy filings accepted grew almost exponentially, with 1,521 accepted cases in 2012, to 9,542 in 2017. A similar development can be observed regarding the number of cases closed: from 1,521 in 2012, to 6,257 in 2017. Most of those cases involve SMEs, but among them are also some high-profile listed players from key industries. One of the reasons for this increase in case numbers probably is a shift in perception among the public regarding the role and implications of a structured bankruptcy procedure. In addition to that, the proficiency of the judiciary has improved over time as well, with to date four specialized bankruptcy courts set up in 2019 in Beijing, Shanghai, Shenzhen and Tianjin accompanied by the establishment of around 100 bankruptcy divisions across the country. Last but not least, like in many other areas of Chinese economy and society, China's use of technology is unparalleled. An online platform called the "National Enterprise Bankruptcy Information Disclosure Platform" specifically designed to make corporate bankruptcy information publicly available and streamline bankruptcy procedures for efficiency and cost-reduction can provide inspiration for other countries. The added value of this platform can be derived from the total number of cases registered on the platform between January 1, 2018, and December 31, 2019: 51,890. By means of comparison, U.S. courts handled 22,245 company bankruptcies in 2018, and 22,483 cases in 2019.

Drawing inspiration from bankruptcy systems in other jurisdictions (namely the U.S. and Germany), there are some particularities of the Chinese bankruptcy system that deserve a closer look, especially with a view to COVID-19 business implications :

Initiating Bankruptcy Proceedings

In China, both debtors as well as creditors are entitled to file an application for bankruptcy if:

- the debtor cannot pay their debts anymore and
- the debtor's assets are less than their liabilities or
- it is obvious that the debtor lacks the ability to pay off all their debts.

In order to determine whether the above-mentioned requirements are met, the court will request the parties to provide supportive evidence (e.g. contracts, balance sheets, auditor's reports etc.).

It needs to be noted that not paying debts or not having enough assets to do so alone is not enough to support a bankruptcy application. Chinese courts assess the application with a view to the existence of both requirements, a lack of either requirement leading to rejection of the application.

COVID-19 Implications:

In light of the extensive support measures rolled out by Chinese government departments on all levels, companies that are currently on the edge of bankruptcy should first assess if and to what extent they might benefit from these COVID-19 company support policies. A critical situation that

under normal circumstances would call for immediate filing for bankruptcy could be solved this way.

Kinds of Bankruptcy Proceedings

One of the main obstacles for the bankruptcy system to be used more frequently in the past was that it was designed to steer bankrupt companies towards liquidation only. In contrast to this inflexible system, the current PRC Bankruptcy Law contains three different procedures that the parties can choose from: *Reorganization*, *Compromise*, and *Liquidation*.

- *Reorganization (or Restructuring)* is mentioned by the law as first of the three procedures, underlining the commitment of the PRC to help companies in need return into the market and thereby stabilizing both contractual relationships and the economy as a whole. At the end of this procedure, a reorganization plan needs to be adopted by the majority of the so-called voting groups (secured creditors, employees, tax and social insurance authorities, unsecured creditors) and approved by the court. It is possible for the debtor to apply at the court for approval to manage their property and business operations under the supervision of the bankruptcy administrator during reorganization. If adoption and/or approval of the reorganization plan fail, the court will rule the termination of the reorganization procedure and declare the debtor bankrupt.
- The debtor can also apply for *Compromise (or Settlement)* after the court has approved the bankruptcy application and before it declares the debtor bankrupt. The advantage of this procedure is that it enables the debtor to seek direct settlement of their creditors' claims. In order to do so, the debtor has to submit a draft settlement agreement that ultimately needs to be adopted by half of the creditors at the creditors' meeting with voting rights who represent at least two-thirds of the amount of unsecured claims. In case no settlement plan is adopted/approved or if the debtor fails to perform their obligations from the settlement agreement, the court will also rule termination of the compromise procedure and declare bankruptcy of the debtor.
- Finally, the third possible scenario of *Liquidation* commences with the formal declaration of bankruptcy by the court. This procedure is targeted at realizing the debtor's entire property by means of auction (if not otherwise agreed at the creditors' meeting) and distributing the proceeds according to a pre-agreed distribution plan. The realized property is distributed in the following order:
 1. *Expenses for bankruptcy proceedings (e.g. property management expenses and administrator's remuneration) and debts for the common good of the creditors (e.g. debts incurred for fulfillment of unperformed contracts, compensation for acts of tort by the administrator's or debtor's employees);*
 2. *Claims of employees incurred before the court accepts the application for bankruptcy (e.g. salary, medical insurance);*
 3. *Taxes and social insurance premiums;*
 4. *Common bankruptcy claims.*

Liquidation ends when there is no more property left to be distributed and the debtor is removed from the company register.

COVID-19 Implications:

The economic crisis caused by COVID-19 is certainly severe, but also finite. It is advisable for affected companies to analyze chances of success for reorganization and compromise with creditors BEFORE formally applying for bankruptcy. Not only can this help identify the most suitable procedure, but it also increases the chances for a faster, time and cost-saving solution without involvement of the court that benefits all stakeholders.

Bankruptcy Administrator

One of the key elements is the bankruptcy administrator designated by the court immediately after admission of the application for bankruptcy. The fact that the administrator is nominated by the court (and not by the creditors' meeting) supports independence and the qualification of the chosen person(s). The creditors' meeting is only granted the right to apply for replacement of the administrator chosen by the court if there are sufficient grounds to believe the administrator cannot perform their duties in an impartial or competent manner. Administrators are usually legal entities selected based on their relevant expertise, such as law firms, CPA firms or specialized bankruptcy liquidation firms. The main duties and responsibilities of the administrator are:

- Taking possession of and managing the debtor's property, business documents and data;
- Assessing the financial situation of the debtor and drafting a corresponding report;
- Handling internal matters of the debtor (e.g. HR matters, daily expenditures);
- Deciding whether or not to continue the debtor's business (with court approval);
- Taking part in litigation, arbitration, administrative etc., procedures on behalf of the debtor;
- Right to propose to hold creditors' meetings;
- Performing other duties assigned by the court which the latter deems appropriate.

To make sure the debtor's property is not illegally reduced so as to jeopardize the satisfaction of all creditors in the process, the PRC Bankruptcy Law also grants the administrator the right to request the court to nullify certain transactions by the debtor done one year before the court accepted the application for bankruptcy, such as transferring property for free or at an unreasonable price, paying off undue debts or abandoning claims. The law goes even further and declares certain acts invalid without any action by the administrator required, such as concealing or transferring property in order to avoid repayment of debts. Property obtained from the debtor through any of the abovementioned prohibited acts can be recovered by the administrator.

COVID-19 Implications:

Debtor companies need to bear in mind the administrator's powers described above, namely with regards to certain transactions taken to reduce the financial burden imposed on them by the virus outbreak that later might be nullified by the court. This applies in particular to debts paid off to individual creditors six months before the court accepts the application for bankruptcy if the debtor already fulfilled the conditions for bankruptcy at the time of payment.

Creditors' Participation in the Bankruptcy Proceedings

One of the primary legal effects of the bankruptcy procedure is that individual realization of creditors' claims is prohibited from the moment the court accepts the application. Creditors have to participate in the process through creditors' meetings (and under certain circumstances a creditors' committee) if they want to enforce their rights. Furthermore, only claims declared by creditors within the time limit determined by the court (between 30 days and three months starting from the

acceptance of the application for bankruptcy) can be considered. The creditor meeting's rights and responsibilities include:

- Assessing the claims of all creditors;
- Supervising the administrator and, if necessary, apply at the court for their replacement;
- Deciding on whether the debtor should continue their operations or not;
- Adopting different plans and agreements (e.g. reorganization, compromise, debtor property management and distribution)

COVID-19 Implications:

There is almost no industry sector not affected by the outbreak of COVID-19. Hence, chances for creditors to face insolvent debtors are real and will continue to be so in the foreseeable future. Thorough analysis of all business partners is highly recommended at this point in time in order to anticipate and prepare well for possible bankruptcy proceedings.

Bankruptcy Assets / Debtor's Property

A debtor's property to be used as a basis for the realization of assets and distribution of the proceeds consists of all property (movable, immovable, intellectual), located in China or abroad (see cross-border implications below), that belongs to the debtor at the time when the application for bankruptcy is accepted as well as property acquired after the acceptance. Notwithstanding the rights that are attributed to the creditors' meeting collectively, individual creditors may also exercise a right to separate their property which is in the possession of the debtor. This needs to be done before the creditors' meeting votes a reorganization plan, liquidation plan, etc. In addition to that, a creditor has the right to offset mutual debts with the debtor provided that the situation does not fall under one of the exceptions explicitly mentioned by the law (e.g. getting into debt to the debtor after knowing about the debtor's incapacity to pay off or the opening of the bankruptcy procedure).

COVID-19 Implications:

The Chinese government has made immense efforts to not let its economy slide into a recession, and bring it back on track as soon as possible. The vast number of support policies is targeted, in particular, at companies operating in industries crucial both during the outbreak (e.g. health care & medical supplies, transportation & logistics, food & agriculture) as well as for China's future economic development (e.g. information technology, communications, critical manufacturing, energy). With regards to the realization of a bankrupt debtor's property, it will be significantly harder to subject certain assets essential in said key industries to normal procedures under the PRC Bankruptcy Law.

Legal Liability

The PRC Bankruptcy Law is complemented by seven provisions on civil, administrative and criminal liability triggered by certain acts or omissions by directors and managers, the administrator, the debtor or persons that are related to the debtor who might serve as a source of information during the process with regards to the debtor's property or financial situation.

COVID-19 Implications:

The PRC Bankruptcy Law stipulates that "[w]here a director, supervisor or senior manager, going against his obligations, fails to be honest and hardworking, which leads to bankruptcy of the enterprise where he works, he shall bear civil liability according to law."

Furthermore, “[t]he person as specified in the preceding paragraph shall not serve as a director, supervisor or senior manager of any enterprise within three years from the date when the procedure for bankruptcy is terminated.” It can be argued that it constitutes a violation of duties in the aforementioned sense if a company is entitled to benefit from any of the innumerable COVID-19 government support measures, but the management fails to take necessary steps, like filing required applications for subsidies or tax relief.

Cross-Border Bankruptcy

One last special feature of the PRC Bankruptcy Law worth being emphasized, in particular given the disruption of global supply chains and transnational economic shocks generated by COVID-19, is the extraterritoriality of the procedure. This means that not only the debtor’s property located in or falling under the jurisdiction of the PRC is included in the bankruptcy process, but also property outside of China’s territory. To date, China has concluded 37 bilateral agreements with different states in the domain of civil and commercial law legal assistance, but not yet contracts specifically governing bankruptcy proceedings. Some of those agreements explicitly exclude bankruptcy from their scope of application, others are silent about it. From this ambiguous observation one may conclude that there is no general will of the Chinese government to include bankruptcy decisions taken by foreign courts into the field of civil law legal assistance. Hence, in order to avoid a conflict of parallelly running bankruptcy procedures and diverging court decisions, Chinese courts will examine a decision made by a foreign court according to the principle of reciprocity and decide, at their own discretion, with a view to safeguarding fundamental principles and interests of the PRC, including state sovereignty and security or legitimate rights and interests of creditors in China.

COVID-19 Implications:

As the vast majority of states have been hit by COVID-19, governments around the globe are at the moment racing against the economic repercussions by enacting emergency legislation in fast-track procedures. Laws and regulations applied under normal circumstances are often suspended and replaced by measures tailored to the current situation. This is the case also for law related to bankruptcy. It is therefore imperative for companies operating in China to see the bigger picture and include changes in other states’ legal systems into their bankruptcy strategy and risk assessment.

3. Important Recent Developments in PRC Bankruptcy

Taking into account the past developments and current status of bankruptcy proceedings in China as described above, one might draw a rather optimistic image of the future. However, the absence of bankruptcy-specific COVID-19 government measures, a still nonexistent national regulation for personal bankruptcy, as well as a lack of broad international recognition of bankruptcy under Chinese law, have been limiting factors to the system’s effective implementation in practice.

We would like to highlight some developments that seem to announce a gradual shift to remedy shortcomings with a view to personal bankruptcy and cross-border insolvency.

No Special COVID-19 Bankruptcy Policies

Unlike Germany, which just passed a law on March 25, 2020, providing for certain relief measures for companies who have or will go bankrupt because of reasons directly related to the COVID-19 pandemic, the extensive enterprise support policies in China do not address risks stemming from company bankruptcy.

Personal Bankruptcy

In contrast to major industrialized countries like Germany, France, the UK or Japan, China is still lagging behind in establishing a comprehensive system for individual persons to file for bankruptcy. The PRC Bankruptcy Law only applies to enterprises with an independent legal personality. For persons like shareholders of a company providing personal guarantees for the company's debts this very often means a serious dilemma as they will be held liable even if the company goes bankrupt, thus culminating in them keeping the company artificially alive. Following the publication of *Guidelines for People's Courts on Enforcement Work (2019-2023)* by the Supreme People's Court in June 2019, that stress the importance of setting up a personal bankruptcy system, a consortium of 13 government departments under the lead of the National Development and Reform Commission in July 2019 agreed on a *Reform Plan for Accelerating the Improvement of Market Entity Exit System*. This document reiterates the government's resolve to establish a personal bankruptcy system necessary to tackle the challenges outlined above. And only shortly after issuance of this government paper, the political will was already transformed into a concrete trial project. The chosen test field was Wenzhou in Zhejiang Province where the Wenzhou Intermediate Court has become the first PRC court ever to approve a settlement agreement between a private person and their creditors and has published (only locally applicable) *Implementing Opinions on the Centralised Clean-up of Personal Debt* to provide judicial guidance for the settlement of similar cases. And although this development is for now limited in its geographical scope and still needs to be translated into nationally and generally applicable legislation, it constitutes an important step towards a more effective bankruptcy system in China.

Recognition of PRC Bankruptcy by other States

In the international context, there is no uniform (or even predominant) legal practice in recognizing the opening of bankruptcy proceedings in China or decisions taken in the course of it. For example, under the German *Insolvency Statute*, bankruptcy procedures initiated in other countries are generally recognized provided that the matter does not fall under the exclusive jurisdiction of German courts and that the opening of the procedure in this other country does not violate fundamental principles and rights of the German legal system.

A similar approach is adopted by the US under its *Chapter 15* of the *United States Bankruptcy Code* that deals with cross-border bankruptcy cases. However, until recently there had been only one instance where US courts formally recognized bankruptcy proceedings taking place under PRC law. This has changed with a decision of the *US Bankruptcy Court for the Southern District of New York* in late 2019 where the court recognised bankruptcy proceedings initiated in Beijing over the property of a company named *Reward Science and Technology Industry Group*. It remains to be seen if this decision will be followed by others of its kind and, even more interestingly, if Chinese courts will adopt a more benevolent approach when confronted with bankruptcy-related decisions taken by US courts in the future.

Another noteworthy incident was the Hong Kong Court of First Instance's decision to recognize the nomination of CEFC Shanghai International Group Limited as administrators under the PRC Bankruptcy Law in January this year. The significance of this decision lies in the extended investigation rights administrators appointed in the course of bankruptcy proceedings on the mainland might exercise upon application with Hong Kong courts. A debtor's assets located in Hong Kong are now very likely to be integrated into insolvency cases initiated in the PRC.

4. Plan of Action for Companies Affected by COVID-19

Despite the remarkable efforts and support coming from the Chinese state as well as the private sector, the economic repercussions caused by COVID-19 will be felt for quite some time by companies of all sizes and across industry sectors. What companies operating in China can and should do now is to pursue a proactive approach to counter potential bankruptcy risks at this still early stage. Some of the measures to be taken to this end include:

- Obtain an overview of and continuously monitor relevant COVID-19 government policies (national, provincial, local)
- Analyze contractual relationships with business partners
- Conduct research on the bankruptcy risks of business partners
- Develop a strategy to be applied in case of bankruptcy of business partners (including debt collection, asset searches and recovery, cross-border analysis)
- Analyze a company's own bankruptcy risk and develop plan of action (including financial status, list of claims and debts, HR issues, COVID-19 enterprise support policies)

Authors:



[Felix ENGELHARDT](#), Associate
felix.engelhardt@eiger.law



[Jackie YANG](#), Associate
jackie.yang@eiger.law

DISCLAIMER

This publication is not intended to provide accurate information in regard to the subject matter covered. Readers entering into transaction on the basis of such information should seek additional, in-depth services of a competent professional advisor. Eiger, the author, consultant or general editor of this publication expressly disclaim all and any liability and responsibility to any person, whether a future client or mere reader of this publication or not, in respect of anything and of the consequences of anything, done or omitted to be done by any such person in reliance, whether wholly or partially, upon the whole or any part of the contents of this publication. This work is licensed under the Creative Commons Attribution-ShareAlike 3.0 Unported License. To view a copy of this license, please visit <http://creativecommons.org/licenses/by-sa/3.0/>.