

China Insolvency Developments: *What U.S. Companies Doing Business in China Must Know*



A Broader PerspectiveSM

The current economic crisis has precipitated numerous bankruptcies and companies in China have not been spared. If you have investments in Chinese companies or are doing business with Chinese companies that are facing bankruptcies, consider your rights and liabilities.

What do you need to do?

- Be aware of creditors' rights in bankruptcy proceedings of a Chinese company; lodge claim on time.
- Be aware of transactions that may amount to fraudulent transfers or unfair preferences.

China's Enterprise Bankruptcy Law, which came into effect on June 1, 2007, deals with the appointment of professional administrator, the increased role of creditors in bankruptcy proceedings, the powers of an administrator to investigate and review questionable transactions, the options to save the company through restructuring and conciliation, and the giving of priority to secured creditors.

Summary

- China has updated its bankruptcy laws that apply to insolvent entities to bring them more in line with international practice. Individuals cannot be made bankrupt in China.
- After a Chinese court accepts a bankruptcy petition, a court-appointed administrator takes control of the debtor company's affairs. Creditors are represented in the bankruptcy proceedings through the Creditors' Meetings and by supervising the administrator through a committee of creditors.
- Apart from liquidating the company, other options such as reorganization and conciliation are available.
- Be aware of transactions that may amount to fraudulent transfers or unfair preferences.
- The company's directors and officers may have civil liabilities if a company falls into bankruptcy due to their failure to be honest and to act with due diligence.
- The Enterprise Bankruptcy Laws apply to all kinds of insolvent legal entities, including state-owned enterprises, private enterprises, Chinese-foreign equity and contractual joint ventures, and wholly-owned foreign-invested enterprises. They do not apply to proprietorships, partnerships and individuals.

Bankruptcy Proceeding Initiation

The debtor company or its creditors can apply to the Chinese court for bankruptcy if the debtor company is unable to pay its debts as they fall due. Additionally, the debtor company applying for bankruptcy must show that it has insufficient assets to pay off all its debts or that it has obviously lost the ability to discharge its liabilities.

How can a creditor's interests be protected?

After a court accepts a bankruptcy application, it will appoint an administrator. The administrator reports to the court but is supervised by a committee of creditors. In the past, a liquidation team acted as the administrator, usually appointed from government officials. Under the current regime, however, the administrator can be a member of a law firm, an accounting firm or a government official. The administrator is required to perform its duties according to law and be impartial.

The duties of an administrator include taking control of the debtor company's property and affairs, investigating financial affairs, and managing and disposing of the debtor company's property. The object is to liquidate the debtor's assets and distribute any surplus proceeds to creditors.

Under the new regime, creditors are represented in the bankruptcy proceedings through the Creditors' Meetings.

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Are there other options besides liquidating the debtor company?

The debtor company, the creditors or investors holding more than 10% of the company's registered capital may apply to the Chinese court for restructuring. If the court approves the application, the debtor company or the administrator must submit a restructuring plan for consideration at a Creditors' Meeting. Unlike many other countries, creditors do not submit draft restructuring plans.

Furthermore, the debtor company may apply to the Chinese court to approve a draft conciliation agreement by first submitting such an agreement to the Creditor's Meeting for approval. Conciliation may involve the debtor proposing a compromise such as a discounted payment to creditors or making payment over an extended period of time.

Are there transactions that may be subjected to questions?

If an administrator finds that there are questionable transactions that amount to fraudulent transfers or unfair preferences, it may apply to the court to declare the following transactions void:

Anytime

- Concealing or transferring assets to avoid liabilities
- Fabricating or recognizing fictitious debt

Within one year before a court accepts a bankruptcy application

- Transferring assets free of charge
- Transacting at an obviously unreasonable price
- Providing security for unsecured debts
- Paying debts in advance of due date
- Waiving of company's claims

Within six months before a court accepts a bankruptcy application

- Paying creditors when the company is insolvent, except where the payment has benefited the company

Creditors who also owe the debtor company may request the administrator to set off such debts against their claims.

Personal Liability

The company's directors, supervisors or senior managers have civil liabilities if the company falls into bankruptcy due to their failure to be honest and act with due diligence. The legal representative of the company and those involved in voidable transactions due to fraudulent transfers or unfair preferences also assume personal liabilities.

Assets Distribution

The order of distribution is as follows:

- Secured creditors
- Bankruptcy expenses
- Debts incurred for the common benefit of creditors
- Amounts owed to employees (e.g., wages, pension fund contributions)
- Tax
- Other unsecured creditors

Creditors must submit their claims to the administrator before a stipulated deadline from the court, failing which the creditor is not entitled to attend the first Creditor's Meeting. The administrator will still consider the creditor's claims, provided the creditor submits them before the assets are distributed. Under the old regime, employees' claims ranked before secured creditors' claims.

Cross-Border Issues

- The law generally extends its application to debtors' assets overseas.
- The law also provides that foreign bankruptcy decisions may be binding on the China based assets of a debtor, subject to relevant treaty provisions, reciprocity and public policies.

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