Impacts of PRC Bankruptcy Law on Safeguarding Investments and Claims

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The PRC New Bankruptcy Law

- The PRC new bankruptcy law was adopted by the 23th session of the Standing Committee of the 10th National People’s Congress on August 27, 2006 and came into effect on June 1, 2007.

- It has had significant impacts on the investment and claims in China.
Impacts of the PRC New Bankruptcy Law

- The new bankruptcy law increases transparency and predictability providing an incentive to investments and lending.

- The new bankruptcy law confirms the creditor’s existing rights and order of priority, increases safety of transaction and creditor’s confidence.

- The new bankruptcy law establishes effective mechanism and improves value of claims.

- The new bankruptcy law establishes effective mechanism to attract post-bankruptcy financing.

- The conflict between bankruptcy law and security law creates risks for secured credit.

1: Increasing Transparency and Predictability

1.1 Transparency

- The former version of PRC bankruptcy law lacks transparency. Many rules of bankruptcy originated from central or local government’s policies so that not all of them were publicly available.

- The new PRC bankruptcy law unified and replaced such government policies with law, and emphasized that bankruptcy shall be conducted according to legal procedures. In particular:
  - related information is required to be disclosed timely and publicly;
  - The debtor has the obligation of information disclosure;
  - the bankruptcy court has the obligation of public announcement;

- As a result, creditors and investors will be fully aware of the bankruptcy activities of debtor and their own rights and obligations in the bankruptcy procedure.
1: Increasing Transparency and Predictability

1.2 Predictability

- The new bankruptcy law sets up a complete legal system which has specific and clear rules for bankruptcy.

- Therefore, creditors and investors are able to predict the impacts of possible bankruptcy of their business partners on the transactions and rights and interests of relevant parties; creditors and investors may also predict the nature of their claims and rights and the arrangements of their benefits if their business partners are in the bankruptcy procedure. Creditors and investors may adjust the terms and conditions and structure of their transactions with their business partners according to the new bankruptcy law so as to maximize protection on their interests.

2: Confirming Creditor’s Existing Rights and Order of Priority

2.1 Confirming existing rights:

- PRC bankruptcy law basically recognizes and confirms rights of creditors and investors existing before commencement of bankruptcy procedure, unless such rights conflict with the public interests, as provided in Chapter 4 of the bankruptcy law.

- Bankruptcy law in principle will not interrupt original transaction structure. During the bankruptcy, both the administrator and the court will generally respect the existing transaction arrangements, and will be very careful to invalidate or revoke a transaction.

- The above will facilitate to stable lending and investment market.
2: Confirming Creditor’s Existing Rights and Order of Priority

2.2 Establishing principle of order of priority:

- Establishing order of priority is a distinguishing feature of the new bankruptcy law.

- The new PRC bankruptcy law provides for several priorities, including secured claims, employment claims and taxes, and also provide clearly for how to handle the conflict between employment claims and secured claims.

- The establishment of order of priority is important to protect rights of creditors and investors and maintain their confidence.

3: Establishing Effective Mechanism and Improving Value of Claims

- The new bankruptcy law provides for effective mechanism and rules, maximizes the value of bankruptcy assets, and increases the value of claims by fair payments, increase in efficiency etc..
3: Establishing Effective Mechanism and Improving Value of Claims

3.1 Maximizing value of assets

- Maximizing value of assets is the core of the new bankruptcy law.
- The new bankruptcy law removes judicial freezing and seizing measures on the bankruptcy assets imposed by non-bankruptcy legal proceedings, which gives the debtor a room for breathing.
- The new bankruptcy law also strengthens the administration of bankruptcy assets and provides for strict examining and approving procedure for usage and disposition of the assets.
- The new bankruptcy law introduces reorganization system to maintain and increase the value of assets as on-going business assets.
- The new bankruptcy law also provides for system of invalidation and revocation to increase the scope of bankruptcy assets.

3.2 Fair payment

- Fair payment is the essence of the bankruptcy law, and a principle of the new bankruptcy law.
- The new bankruptcy law provides for equal opportunities and rights for creditors to participate, and provides that claims of the same nature should receive equal treatment.
- The law introduces 'automatic stay', prohibits payment to individual creditor, and avoids debtor's fraudulent transfer and preferential treatment.
- The law categorizes claims for voting so as to ensure equality and justice regarding the reorganization plan and distribution mechanism and procedure.
3: Establishing Effective Mechanism and Improving Value of Claims

3.3 Increase in efficiency

- PRC bankruptcy law asks for efficiency, through which the value of assets and claims may be increased.
- The new bankruptcy law clearly provides for time limit for each phase of the bankruptcy procedure in order to urge parties to perform their duties in a timely manner.
- The new bankruptcy law also provides that all the litigation proceedings involving the debtor shall be governed by the bankruptcy court to save judicial resources.
- The new bankruptcy law provides for effective operating rules of authorities and improves decision-making and executive ability.
- The new bankruptcy law sets up a transforming system from reorganization to bankruptcy liquidation to increase flexibility.

4: Establishing Effective Mechanism to Attract Post-bankruptcy Financing

- It is vital for the debtor to maintain operation in bankruptcy in particular the reorganization procedure. To maintain its business operation, the debtor must have enough cash to pay wages and costs of procuring key products and service etc.
4: Establishing Effective Mechanism to Attract Post-bankruptcy Financing

4.1 Sources of financing

- In practice of the new bankruptcy law, there are two sources for financing after the bankruptcy procedure starts:
  - The first is shareholders, creditors, etc. which hold stake in the debtor; their purpose is to obtain the income or new value generated through lending new money or revive the debtor, so as to reduce losses and damages caused by previous investments or transactions; and
  - The second is financial investor which does not have existing stake in debtor, such as PE fund or vulture capital. Their purpose is to achieve high profit through funding the debtor.

4.2 Safeguarding measures for post-bankruptcy Financing

2 measures:

- Lists post-bankruptcy financing as common benefits debt.
- Uses debtor’s assets to provide security to ensure the priority of new loan.

This is a new area and also a new challenge for the PRC bankruptcy law in particular for reorganization system. In practice, the following major issues exist:

- In China, the concept of providing financing to a debtor in bankruptcy has not been formed and there is no effective system for such financing; and
- The circumstances of debtors in China do not encourage lenders to provide new money. In general, the assets quality of debtors in bankruptcy procedure are poor, the debt ratio is high and the assets normally have been mortgaged and can not be used to provide security for the new money.
The conflict between bankruptcy law and security law creates risks for secured credit

5.1 The conflict between secured claims with employment claim:

- According to the new bankruptcy law, the employment claim formed before 27 August 2006 may be repaid before secured creditor if such employment claim can not be fully repaid based on the general distribution procedure provided by the bankruptcy law.

- This is consistent with the practice in China before the new bankruptcy law came into effect.

- Such cases in practice after the new bankruptcy law are rare.

- From the perspective of bankruptcy law, the secured claim will be affected by such employment claim.

5.2 The pledged equity of a company may be adjusted when entering into the reorganization procedure.

- When a company is in the reorganization procedure, if the equity of the company has been pledged to a third party and such equity is adjusted downward in the reorganization procedure, the right of third party will be affected substantially. This is a major issue in reorganization cases.

- From the perspective of bankruptcy law, when a company is insolvent and enters into reorganization procedure, if the interests of creditors can not be realized in full, the equity of shareholders shall be decreased or deprived.

- From the perspective of security law, without consent of pledgee, the pledged equity shall not be decreased.

- This issue has caused a lot of discussion in bankruptcy practice of China. Once the bankruptcy rules are set up, this will create impact to the security law and cause huge risks to pledge on equity and will affect the recovery of loan and claims.
5: The conflict between bankruptcy law and security law creates risks for secured credit

5.3 Risks of loss and damages faced by secured assets during the reorganization procedure when secured claims are prohibited to be realized.

- According to the new bankruptcy law, during the reorganization procedure, the secured creditor can not take action to realize its secured claim.
- Although the law has provided for remedies for such situation, this has caused issues in practice.
- For example, in the reorganization of Changchun Lide (Changchun Lide Automotive Engineering Plastic Products Co Ltd.), the secured creditor applied to the bankruptcy administrator for a foreclosure on the secured assets but was rejected. The secured assets was continued to be used in the reorganization procedure and some risks and damages arised.

5.4 Cram down

- In recent years, several court decisions of cram down could significantly affect the rights and negotiation position of secured creditors in reorganization cases.
- In the case of ST Jinzhou Chemical (Jin Hua Group Chlor-Alkali Co., Ltd.) reorganization case, the secured creditor objected to the appraised value of mortgaged asset and the repayment and therefore object to the reorganization plan.
- But the court hold that the plan of reorganization satisfies the cram down provisions with respect to secured creditors set forth in bankruptcy law, and finally ratified the plan.
6. Contact Information

Thank you!

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