

A Summary of the Position on Cross-Border Insolvencies and Debt Workouts in China

Dr. Jingxia Shi

I. Cross-Border Insolvencies in China

1. Legal Blank on Cross-Border Insolvency

China lacks as yet explicit legislation on cross-border insolvency at a national level. 1986 Enterprises Bankruptcy Law (EBL) only applies to the SOEs. The bankruptcy section in the Civil Procedure Law (CPL, 1991) is too simple to address any specific issue on cross-border insolvency. There are very few articles concerning cross-border insolvency in the New Rules recently promulgated by the Supreme People's Court which I mentioned in the session 3. Interestingly, however, bankruptcy provisions for foreign-related enterprises once were developed at a local level in Guangdong Province and Shenzhen Special Economic Zone (SEZ) in 1986. But those provisions were replaced by new regulations which do not involve cross-border insolvency in 1993.

2. Difficulties in Judicial Practice

In fact, the issues associated with cross-border bankruptcy do exist in China's economy life in spite of the legal blank. On the one hand, various foreign-related enterprises in China are often affected by foreign bankruptcy adjudication. In the event that the foreign investor (whether individual or corporation) has been declared bankrupt in a foreign jurisdiction, the status of the debtor's assets situated in China will inevitably become a tough issue. On the other hand, the Chinese bankruptcy proceeding may concern many foreign creditors and assets of the debtor located outside China.

The legal blank on cross-border insolvency gives rise to various difficulties in judicial practice. There are several cases indicating incoherent attitudes of Chinese courts towards solving these problems, such as LMK Nam Sang Dyeing Case, Liwan case, BCCI case, etc. In particular, since early 1999, as the first case concerning the bankruptcy of leading state-owned financial institution in China, the Guangdong International Trust & Investment Corporation (GITIC) case involves the largest-ever amount of assets and foreign creditors, contributing a lot to the debate on cross-border insolvency home and abroad although this case was ended up on February 28, 2003. GITIC case has raised several noteworthy legal issues, such as the equitable treatment for creditors and registration of foreign debts, letters of comfort, liquidation committee and voidable transaction, etc.

3. Recent Change: Judicial Practice and Pending Legislation

Notably, the situation recently gets improved in China, which can be observed from both its judicial practice and pending legislation. For example, in the B & T case, Chinese court formally recognized the bankruptcy order made by a foreign court for the first time. In this case, the applicant, an Italian company applied to Guangdong Foshan Intermediate People's Court for recognizing a bankruptcy judgment and an adjudication order made by an Italian court. Foshan Court granted these applications but no further actions were brought about due to some ill-defined reasons.

The second case deals with the Hong Kong High Court's recognition of GITIC bankruptcy proceeding taking place in the Mainland China. This case took place between CCIC Finance Limited (CCIC, plaintiff) and GITIC (defendant) and GITIC Hong Kong (Holdings) Limited (GITIC HK, Garnishee). The core issue concerns the extraterritorial effect of GITIC proceeding opened in the Mainland, particularly, can this proceeding affect the assets of GITIC in Hong Kong? The orders made by Judge Gill indicate the recognition of GITIC proceeding. The underlying reason for the recognition mainly lies in the understanding that the bankruptcy liquidation of GITIC is pursuing a universal collection and distribution of whole assets of GITIC and all creditors in the same rank, whether Chinese or foreign, obtained dividends under *pari passu* principle. As the first case recognizing the bankruptcy proceeding in the Mainland, it may produce very positive implications on China's future judicial practice on cross-border insolvency, particularly requiring Chinese courts to treat all creditors fairly.

In the Draft Enterprises Bankruptcy and Reorganization Law of the PRC (2002), there is one article on cross-border insolvency. Article 8 states thusly:

"The liquidation, reorganization or composition proceedings opened by the People's Court under this law shall have effects on the assets of the debtor located inside and outside of the territory of the PRC.

The application filed by the party concerned for recognition and enforcement of a liquidation, reorganization or composition proceeding opened outside the territory of the PRC shall be subject to the approval by the People's Court.

In the case that the foreign proceeding falls into one of the following circumstances, the People's Court may make a decision of not granting the recognition and enforcement:

- 1. There is no relationship based on the treaty or reciprocity between the PRC and the foreign jurisdiction where the proceeding is opened;*
- 2. The recognition of the foreign proceeding will violate the social public interests of the PRC;*
- 3. There exist significant differences in respect of substantive provisions between this Law and the bankruptcy laws of foreign jurisdiction where the proceeding is opened, which are possibly detrimental to the interests of Chinese creditors."*

This article generally adopts the revised universality principle after lengthy discussion. It may be hailed as a welcome progress, compared to relevant

article in the 1995 draft that sticks to the territoriality principle. But in effect, the conditions on recognition of a foreign bankruptcy proceeding are strictly listed. It may be not easy for a foreign proceeding to obtain recognition in the PRC since one of the conditions set out in this Article 8 is easily satisfied. Therefore, it is by all means a matter of discretion for the Chinese court to decide whether to recognize a foreign proceeding or not.

II. Cross-Border Workouts in China

1. Relevant Background

As mentioned above, China has a dearth of national legislation on cross-border insolvency, not to mention the provisions on informal workout. Against this backdrop, western-style workouts are relatively new phenomena for China. But recent years have witnessed some large-scale workouts concerning foreign creditors. Since the 1997 Asian financial crisis, Chinese banking sector is also in financial difficulty, resulting in some efforts towards out-of-court workout. But generally, the debtor heading for workout is large SOE currently in China although no laws or regulations strictly make such limitation. Thus it is necessary to put most issues in relation to workout into this context for examination.

One of the workout approaches being tried is called Changchun Approach (Professor Wang will address it in session 6). To some extent, however, the Changchun regime focuses on the bank rather than the creditors generally. The system is premised on trying to please the bankers so they will participate in the workout. Currently the relevant authorities of the PRC is considering how to improve this approach and produce a regime that will address their main concerns as well as perhaps be internationally accepted.

On the demand side, Assets Management Corporations (AMCs) that are responsible for disposing of NPLs were set up by four major commercial banks in China several years ago. One of the AMCs' main strategies for disposal is selling these NPLs to foreign investors. This is a deliberate strategy by the PRC government to examine the application of international workout and collection techniques to NPLs, how effective that is as a process for collection, and to see what effects the collection process has on wider social objectives like employment and stability in local communities. Over these years, each of the four AMCs actually took active steps to manage their NPLs and indeed sold part of their NPLs to foreign investors.

China has a tradition of administrative rather than legal responses to problems, so it may be expected that entities such as AMCs may play a role in the workouts. Even if a formal court-based reorganization system is established in future, an out-of-court workout process involving the use of AMCs is also necessary to address problems in the financial sector.

2. GDE Workout Case

Up to now, the most prominent workout case in China is Guangdong Enterprise (GDE), a provincial holding company. Following the bankruptcy of GITIC, Guangdong Provincial Government (GPG) announced that its largest window company in Hong Kong, Guangdong Enterprises (GDE), was also insolvent. But different from GITIC, GDE would embark on a restructuring process, with adherence to internationally recognized standards. Thereafter, GDE was officially in a debt restructuring, also commonly referred to as a workout. As the largest ever workout of SOEs, GDE is widely regarded as the blueprint for PRC workout. It took over two years to complete. Possibly it is the most complex workout anywhere in the world, ever seen as a test case of China's economic reforms. Moreover, as GDE is incorporated in Hong Kong and has five key subsidiaries listed there and in Macao, the lessons of the case may be more relevant for other window companies than for ordinary Mainland Chinese debtors.

When it was insolvent, GDE had US\$5.8bn debts, 90% unsecured. Among its more than 1,000 creditors in total, there are 170 bank creditors. GDE had over 300 operating subsidiaries in the Mainland China, Hong Kong, Macao, Thailand, Cambodia, France, etc. Moreover, its cash flow was negatively operational, and had continual strained relations with creditors, both foreign and domestic. GPG/GDE hire Goldman Sachs as financial advisors. GDE calls for a standstill in January 1999. Goldman presented a workout proposal in May 1999, but was rejected by foreign creditors in June 1999. Then, GPG/GDE stop interest payments in response to the foreign creditors' rejection. After a period of due diligence, negotiations commence in earnest in October 1999. These negotiations lead to an outline deal (described as a "summary non-binding indicative heads of terms") in December 1999. A full year of negotiations as to the detailed terms of the deal follows over the course of 2000. The workout was finally signed, sealed and delivered on the last working day before Christmas 2000.

3. How are informal workouts involving foreign creditors handled?

(1) Taking Over of the Local Government

Once an informal workout process is commenced, the local government where the enterprise is located often directly or indirectly controls the process, takes over the management of a corporation, responsible for case administration. The former management remains involved at a cosmetic level, but no decisions are made without the approval of the local government. Depending on the issues involved, even the central government may control certain aspects of the process. The level of involvement of the government and the level of government that should be consulted is sometimes uncertain. This could be one of the difficulties faced by foreign creditors in PRC workouts.

(2) The Creditors' Meeting and Standstill

After the initiation of a workout process, there is usually a standstill of creditors. In fact, the main goal of the first creditors' meeting is often to convince all creditors to grant standstill, without taking any aggressive action against the debtor. There exist often no major barriers in this respect. On the one hand, the debtor's domestic creditors will also normally standstill, usually at the behest of local government officials. On the other hand, the foreign creditors will normally agree with this request to standstill, either informally or in writing. The reason for this is that they know instinctively that debtor's situation is serious. Rather than taking any rash actions which could force their fellow creditors to follow suit, it is probably appropriate to first get a better understanding of the debtor's present circumstances and any suggested solutions, and then decide what to do next.

At the same time, at the creditors' meeting, many creditors will form a view on management of the debtor and see if the management is faithful. Thus sometimes the creditors' meeting can be very challenging for the debtor and management, they will be asked to provide thoughtful and candid answers to some difficult questions. The second creditors' meeting can be a trying time for the debtor management and local government, as no matter what portrait of the debtor is painted, the foreign creditors will often be unhappy.

(3) The Business Review Report

In the workout process, the business review report of the debtor is very critical in twofold meanings. First, the findings and recommendations of the report can be very important reference for creditors to make their decisions. The business review report revealed all about debtor's finances and operations. What will the creditors do next? The decision will be dependent on many factors including their assessment of the viability of the underlying businesses of the debtor, likely to be based on the business review report and on their faith in senior management.

Second, the business review report also provides answers to some questions that the foreign creditors want answers. In particular, if the report indicates significant financial problems but a viable underlying business or businesses able to generate cash flows to service debt, there will normally be a basis for a workout. However, if the underlying businesses are not deemed to be viable, then relevant government support becomes most important to ensure that a workout is possible.

Given the significance of the report, before the business review report is issued to foreign creditors, it was first presented to debtor management in draft form for their review, comments and confirmation, ensuring the numbers and other information are correct to the best of their knowledge.

(4) Workout Plan

Proposing a workout plan that will satisfy creditors constitutes a crucial step to achieve a successful workout. Responsibility for the workout plan usually

resides with the lawyers acting for the steering committee of the foreign creditors, in conjunction with the financial advisers, acting for the debtor/local government. While the debtor has the contractual relationship with its financial advisers, it is common for the relevant local government to act independently of the debtor's financial and legal advisers. Indirectly, the local government makes many of the decisions about the workout, as in effect, there would be few, if any, assets available to foreign creditors without the government support.

Among various elements for a workout plan to be considered, cash flow projections should be prepared to demonstrate the debtor's ability to generate enough cash in the future. The debtor's projected cash flows from its new, restructured entities will form the basis for any workout proposals regarding its existing debts. If the projected cash flows appear to be sufficient to repay all outstanding indebtedness over time - from operating sources or from asset sales - then the debtor's existing debts will most likely be re-scheduled accordingly. This is called a self-rescue, it means that the debtor has traded or managed itself out of its difficulties. The creditors will normally be happy to accept such a scenario, as it sees loans being repaid in full, albeit over a longer period than originally anticipated. If the debtor's projected cash flows are insufficient to repay all existing indebtedness in full, then management has to ask the creditors to accept a haircut.

PRC workout plans usually include government injections of assets into the company, assets sales, and/or one-off cash payments. For example, the workout plan presented by GPG and Goldman Sachs advisors combined asset injection, debt/equity swap, debt rescheduling and conversion, sell-off of non-core businesses, the creation of a new "good" company, etc. Creditors would be spared explicit haircuts, but would see US\$3.9 billion in mostly short-term claims exchanged for US\$1.8 billion preference shares, US\$1.8 billion long-term notes, and US\$0.3 billion in cash.

(5) Injection of Valuable Assets

A government injection of assets into the troubled company is a very common component of PRC workout. Asset injections are used primarily when the debtor's underlying businesses are low cash flow producers and do not produce sufficient cash to repay creditors. Asset injections may take many forms, ranging from cash flow generating businesses to developed and undeveloped property, to cash. For example, in the GDE workout, GPG injected a water-supply company which supplies Hong Kong with the majority of its water with high cash revenue. However, the extent to which asset injections coupled with the company's existing assets are capable of producing the necessary cash flows to repay all of a company's indebtedness varies from company to company, and creditors may not always expect that they will be sufficient to enable them to receive full repayment over time.

(6) Asset sales

Virtually all PRC enterprises undergoing a workout have surplus assets that are not fundamental to the operations of the business. One of the most common reasons why they are having to workout is because they borrowed short-term funds to purchase such assets. These surplus assets usually include interests in such property as hotels and office buildings, property development projects and other businesses unrelated to the company's core operations. While many of these assets will be minority shareholdings, many will be fully owned. And if not property related, they will usually be unencumbered. Many PRC workout plans including DGE case will see at least one component being the sale of such surplus assets.

(7) One-off payments

In some cases, foreign creditors do not like workout plans providing payments over time due to the uncertainty involved. They prefer to having a quick exit via a one-time discounted payment in full and final satisfaction of their claim. Such a payment will normally require government financial support. Some PRC workout plans will offer creditors the choice of either a long-term plan or a one-off plan. The key to creditors' decisions depends on many factors including provisioning policies and the amount of discount offered or required.

4. How are foreign creditors treated in cross-border workouts?

In terms of the treatment of the foreign creditors in relation to an informal workout, the starting point, in theory, is to treat creditors both foreign and domestic in the same way. In a proceeding opened in China, whether it is a formal insolvency or informal workout, the foreign creditors will not be given unfavourable treatment only if their claims are proved. Both the above GITIC and GDE case can be examples in this respect. In fact, China does care what the rest of world would say about its foreign and open policy and pays much attention to its self-image in international community.

But there is a problem on the secured creditors since it is common for all creditors to be treated identically, irrespective of class in the PRC workout. The local government often supplies the assets/funds to support the workout. Usually, the assets/funds are available for all creditors whether they are secured or not. Creditors holding guarantees may often be treated no differently to those without guarantees.

The position of both unsecured and secured creditors who vote against, do not agree with, or do not consent to, a workout plan in an informal workout will depend on the terms of workout and whether there is a standstill agreement whose terms have been breached. In the absence of any formal standstill agreement (which is common) and assuming creditors have reserved their rights throughout the negotiation process, it seems possible for creditors to freely exercise their legal rights although this is not advised here.

5. What is the approach to cross-border insolvency issues in formal

insolvencies and how does that affect informal workouts?

There is no clear stance on cross-border insolvency currently in China due to the lack of relevant legislation. It is assumed that this situation may affect informal workout from two aspects:

First, suppose a workout happens in another country and a formal insolvency in China. It is possible for China not to recognize a workout opened outside of China as some cases indicated a territorial approach adopted by Chinese court. If the debtor has some assets in China, Chinese court may open a formal insolvency. In the event that the foreign workout does not concern the assets located in China, whether to participate in the foreign workouts, to a large degree, may subject to the decision of Chinese creditors.

Second, suppose a workout happens in China and a formal insolvency happens in another jurisdiction. It is also difficult for China to recognize the effect of foreign insolvency unless there is a treaty or reciprocity relationships between China and relevant jurisdiction.

In reality, foreign workouts sometimes have no much influence on the business of the debtor in China, such as the Daewoo's restructuring in South Korea, the workout of Sogo in Japan. The business in China is just seen as the part of the debtor's property and these businesses operate normally, so the workout plan does not concern complicated issues of debts in China.

6. What issues arise in international workouts?

The main issues of workout in China lie in the following aspects: to the local government, they still lack of relevant experience; to foreign creditors, they lack of knowledge of the Chinese laws and the way in which local government expect the workout to be. For example, in the GDE case, one of the stances of GPG is to share the losses between the shareholders and creditors. It took a long time for foreign creditors to accept this argument. There are some more concrete issues:

First, workouts in China are different from those developed in the rest of the world because most Chinese entities undergoing a workout process are SOEs, with few assets that are able to generate significant cash flows. Therefore, in order to restructure and repay creditors, government financial support is very crucial to the success of workout. In practice, government support can take some different forms. Under most circumstances, the level of experience of the relevant local government in workout determines the nature of the workout. To foreign creditors, local governments that are involved in a number of workouts may be more open in this respect and more likely to provide support.

Second, there may be a dichotomy of stance between foreign creditors and domestic creditors in the workout. Foreign creditors are prepared to accept haircuts but wish to see the loans recovered as soon as possible, whereas local creditors are prepared to accept the rescheduling of loans for extended periods subject, however, to there being no reduction in the loan principal repayable since Chinese regulations potentially require them to do so to some extent.

Thus, the debtor faced with both categories of creditors has to navigate skillfully and creatively if their workout proposals are to be acceptable to all creditors. This is not an easy task and may delay unreasonably the process of the workout. Such recent workouts as GZITIC reflect this situation.

Third, in relation to the need for the debtor to obtain urgent working capital funding, there are some difficulties encountered in the provision of such funding in an informal workout. Generally, the enterprise will effectively cease operating or the local government will support the debtor's business operations—usually on a scaled-down basis—until the rescue is implemented. Where new money is required, it is open for the debtor to request the banks to advance funds with appropriate security and assurances. In practice, this is rare, there are some difficulties to enforce security and guarantees from the government are no longer given. It has been observed that foreign creditors now require the local government to provide strong support or even contribute the vast majority of the new funds itself. It may be very difficult for some local governments whose financial status is not very good to do so. This situation may result in the failure of workout.

7. How could the operation of international workouts be improved?

In each country and region there are unique attributes to the workout process. There are different players, different driving forces. It may be very difficult to achieve a successful workout. Likewise, workout in China has its unique characteristics—from government involvement and red tape to a less-than-apparent approval process – but they seem to work, offering foreign creditors significantly better deals than what they could obtain in a liquidation proceeding.

GDE shall be regarded as a successful workout in China. It can be observed from GDE case that the workout is pretty favorable as China is receptive to international principles and western ideas. The debtors have been serious in carrying out their workout plans. Of course, it is also necessary to adapt western ideas to the PRC context. But after all, China has no set of rules on informal workouts until now although it is receptive to accept the western ideas. In the long run, it is advisable for China to formally enact such rules as the Statement of Principles for a Global Approach to Multi-Creditor Workouts by INSOL International to improve the workout process.