Cross-border Insolvency Issues – Mainland China & Hong Kong --What will the Article 7 of the New EBL Bring?

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I. Introduction

China lacks as yet explicit legislation on cross-border insolvency at a national level until the New Enterprises Bankruptcy Law gets passed in this June. Despite this, the issues in relation with cross-border bankruptcy do exist in China's economy life. 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 void on cross-border insolvency gives rise to various difficulties in judicial practice that you can see from several cases below. This, together with the pressing need to accommodate our legislation with market economy, makes it very necessary to add articles on cross-border aspects to our new legislation and gives birth to article 7 of the New EBL. I originally put this article into our draft EBL. As the first article clearly dealing with cross-border issues, it will give guidance to Chinese courts on how to hear the bankruptcy cases involving foreign elements, which hopefully can bring China's legislation and practice into a new stage in respect of cross-border issues. But regretfully, it is not enough to only have this article, so how to enact more detailed rules still remains a task before us. In the following sections, I will try to talk about the relevant legislation and practice prior to the New EBL concerning cross-border aspects so as to give a clear picture of the background of article 7. Then, the next practical step to facilitate the Chinese court to hear the cross-border cases will be briefly discussed and explored.

II. Relevant legislation and regulation prior to the New EBL

In contrast to China's centuries-old history, Chinese bankruptcy law is still in its infancy period. Before the New EBL get passed, the bankruptcy system of China consists mainly of 1986 Enterprises Bankruptcy Law of PRC (Trial Implementation, hereinafter "the Old EBL"), Procedure for Bankruptcy and Debt Repayment provided in the 1991 Civil Procedure Law (hereinafter “CPL”), Provisions on Some Issues Concerning the Trial of Enterprises Bankruptcy Cases Promulgated by the Supreme People’s Court (hereinafter “SPC Judicial Interpretation”), other accompanying judiciary opinions and relevant regulations.

1. 1986 Old EBL

China does not apply its bankruptcy system uniformly. The Old EBL only applies to the State-Owned Enterprises (SOEs) and is composed of only 43 articles included in six chapters, involving bankruptcy filing and case acceptance, creditors’ meetings, reconciliation and reorganization, bankruptcy declarations and liquidation. As the first bankruptcy law in China, EBL actually embraces the dual policies of restricting substantial application of bankruptcy remedies and emphasizing conciliation. Besides, the absence of true market indicators and relevant legislation leads to inactive application of the Old EBL in China. Such factors as inaccurate analysis of a company’s efficiency, effect on banks and other state-run firms, and interconnection between the judiciary and the administrative arms of the government, conspire against courts’ applying the Old EBL to liquidate insolvent SOEs. As a result, the bankruptcy cases are rare in Chinese court despite the existence of a considerable number of technically insolvent SOEs.

When it comes to cross-border insolvency, the Old EBL excludes all vehicles for foreign investment. As a matter of fact, in hearing the GITIC case, this Law is clearly far enough to address the complicated issues in this case, particularly the assets of GITIC located outside the territory of Mainland China.

2. 1991 Civil Procedure Law

The bankruptcy provisions in the 1991 CPL are too simple to address any specific issue on cross-border insolvency although it may apply to the foreign-related legal person. This section includes only 7 articles and keeps silent on the cross-border aspects.

3. Two repealed local regulations (Guangdong & Shenzhen)

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.

Shenzhen Regulations stated that a bankruptcy declaration made in accordance with the bankruptcy law of a foreign jurisdiction shall be of no effect against the property of the debtor situated in the Shenzhen SEZ. It remained unanswered as to what kind of effect of Chinese proceeding upon the assets of the debtor located outside of China.

When the foreign liquidator or creditors demand the takeover of the debtor's assets situated in China, the approach of share transfer is preferred than that of direct turnover. Under the Guangdong Regulations, a foreign liquidator would have been entitled to make suggestions about the disposal of foreign debtor's assets in Guang Dong Province. The debtor's assets, however, shall be generally disposed of by the way of share transfer. It is noteworthy that there are different requirements on share transfer, given the divergent vehicles of foreign-related enterprises. The procedures for share transfer involving wholly-owned foreign enterprises is simpler than those regarding sino-foreign joint ventures. The latter shall be subject to the approval of the Chinese partner whereas the former is not subject to this requirement. The rationale behind this distinction is to protect the Chinese partner against unwanted loss owing to the foreign partner's bankruptcy. In addition, share transfer must receive the necessary sanction from the local Municipal People's Government. Proceeds from the share transfer must not be transferred out of the SEZ until the liquidation expenses, taxation and other local liabilities had been repaid.

These provisions were designed to meet the requirements that combine fixity with flexibility. On the one hand, the bankruptcy of a debtor in its foreign jurisdiction does not deprive it of the capability of disposing of its own assets located in China. On the other hand, permitting the debtor to retract his assets in China by way of share transfer and then to incorporate them into the bankruptcy estate does not affect the business operation, thereby protecting the interests of the Chinese partner. But in practice, it is very difficult to keep absolutely the foreign-related enterprise from adverse effects once the investors failed in foreign jurisdictions. Furthermore, these provisions drew lots of criticism from foreign creditors towards the administrative intervention in the process of assets disposal. Thus it is not surprisingly that those provisions were replaced by some other regulations that do not involve cross-border insolvency in 1993. It may be worthy noting that the concepts and ways of dealing with these cases remain meaningful to date.

4. 2003 Judicial Interpretation by the Supreme Court

The SPC Judicial Interpretation applies to the bankruptcy of various kinds of enterprises. There are very few articles concerning cross-border aspects in the Judicial Interpretation on hearing the bankruptcy cases. It should be noted that article 73 of the SPC Judicial Interpretation states that the bankrupt enterprise's properties outside the territory of China shall be recovered by the liquidation team. It can be inferred that the bankrupt enterprise's properties shall include those assets located outside the territory of China although it gives no explanation to the meaning of "all assets". But the SPC Judicial Interpretation keeps silent on how to recover those properties, which could be a practical problem difficult to solve due to lack of relevant supporting details.

III. Recent Court Cases in Mainland China

There are several cases indicating incoherent attitudes of Chinese courts towards solving cross-border insolvency issues, such as GITIC case, B & T case, etc.

1. GITIC Case

As the first case concerning the bankruptcy of leading state-owned financial institution in China, the GITIC case involves the largest-ever amount of assets and foreign debts in China, drawing international-wide attention in short time.

On 16 January 1999, Guangdong International Trust and Investment Company (hereinafter "GITIC") was, under the EBL, declared bankrupt by the Guangdong People's High Court because of its inability to pay maturing debts. A creditors' committee was set up at the first creditors' meeting in April 1999 to oversee the disposal of the GITIC's assets. In order to protect lawful rights and interests of GITIC's creditors, Guangdong provincial government took unprecedented steps of calling together municipal and county government officials to urge them to force local debtors to pay back what was owned to the GITIC. The courts at all levels in Guangdong issued orders and announcements to all debtors and guarantors that outstanding funds must be paid. The courts tried to get back the debts by freezing, confiscating and auctioning the assets of debtors.

After four years' investigation and legal hearings, the GITIC bankruptcy case ended on 28 February 2003. And a total of 2.536 billion yuan (US$305.54 million) has been repaid to GITIC's creditors over the past four years. The payment mainly came from public auctions of GITIC's properties, including the 63-storey GITIC Plaza. Overall, creditors expressed satisfaction with a recovery rate reaching 12.54 per cent and the speed and efficiency of Chinese courts in handling the high-profile case. But in any event, this case also reflected the inefficiency of the Old EBL and the Guangdong High Court encountered various difficulties in hearing this case.

2. B & T Case

This is the first case in which the Chinese court formally recognized the bankruptcy order made by a foreign court. In this case, the applicant, B&T Ceramic Group s.r.l.(B&T), domiciled at Via Calzavecchio n.23, Casalecchio d/R (Bologna), Italy, filed a petition on 18 December 2000 to applying for recognition and enforcement of the judgments and related matters made by an Italian Court.

Guangdong Foshan Intermediate People's Court hearing this case took the view that the No. 62673 Bankruptcy Judgment made by Milano Court (Italy) on 24 October 1997 and the Adjudication Order on the Transfer of Confiscated Assets made by Civil and Penal Court in Milano (Italy) on 30 September 1999 conform to the conditions on recognition of judgments and decisions made by foreign courts specified in the Treaty on Judicial Assistance in Civil Matters between the People's Republic of China and the Republic of Italy (hereinafter 'The Treaty between China and Italy') and Chinese other relevant laws. The validity of the Bankruptcy Judgment and Adjudication Order shall be recognized accordingly in China.

B&T case is, to this author's knowledge, the first case in which Chinese court formally and explicitly recognize the validity of bankruptcy judgment made by foreign court. In this sense, it is of significance of landmark despite that the PRC does not for various reasons embrace the Common Law principle of binding precedent. This case to some degree could serve as an indicator on several elements when recognizing foreign bankruptcy by Chinese courts.

IV. Recent Court Cases in HK

1. CCIC v. GITIC

This case deals with the Hong Kong High Court's recognition of GITIC bankruptcy proceeding taking place in the Mainland China. It 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.

2. NEMM Case

In 2002, the liquidation order of Northeast Electrical Transmission & Transformation Machinery Manufacturing Company (**"NEMM"**) drew a lot of attention in Hong Kong and Mainland China. NEMM is a large state-owned enterprise and an oversea-registered company in Hong Kong.   It is a matter of public record that shares of NEMM are listed both on the Hong Kong Stock Exchange as H shares and in Shanghai as A shares.

A creditor once seeks to wind up NEMM in Hong Kong under s.327 of the Companies' Ordinance. The hearing was scheduled in June 2002 in the High Court of Hong Kong. At the hearing, the creditor applied for an adjournment of the proceedings, effectively, to explore options with NEMM and test the viability of those options. The proceedings are not defended by NEMM.

In this case, one of the legal issues is whether an H-listing or other listing held by a foreign company, on the Hong Kong Stock Exchange, is an asset of the company with that public listing. At first sight, one might safely assume that a listing is not an asset of any sort and it is certainly not an asset of the company whose shares are listed. Actually it remains open as to whether the listing would be treated in the same way by Hong Kong Courts for the purposes of s.327 of the Companies' Ordinance.

As an additional factor which Courts should consider when exercising their discretion to wind up a foreign public company, it is suggested that a Hong Kong Court should be slow to sanction the trading of an insolvent company on the Stock Exchange of Hong Kong, wherever it was incorporated.

The other issue is the complexities of cross-border aspects upon the making of winding up order of a foreign company. In the case of a PRC state-owned enterprise, the effect of the making of a winding up order against it in Hong Kong, is that the SOE is in liquidation in Hong Kong and under the control of a Hong Kong liquidator with respect to any assets worldwide, in jurisdictions which will recognise his authority.

In respect to the NEMM case, there was a seemingly happy result. Thanks to the huge financial support and a series of equity arrangement of Shenyang municipal government, NEMM disengaged the fate of being liquidated in Hong Kong and it repaid the loan owing to the creditor and plaintiff, CCIC. But the same issue has arisen in the recent Zhu Kuan Group case.

3. Zhu Kuan Group Case

This case was heard in November and December 2003, and judgment was made on 2 August 2004 by the High Court of Hong Kong SAR. In this case, Zhu Kuan Group Company Limited ("ZK Group") filed an application to strike out a winding up petition presented against it by Standard Chartered Bank ("SCB") on 12 August 2003, on the ground that the court has no jurisdiction to wind it up and/or that there is a more appropriate forum (namely, Macau) in which it can be wound up. As an alternative to striking out, ZK Group sought an order varying the powers of provisional liquidators who were appointed in respect of it on 13 August 2003 so that such powers were restricted to ascertaining and taking possession of its books, records, properties and other assets within Hong Kong, on the grounds that the court has no jurisdiction over its assets located outside Hong Kong.

ZK Group is incorporated in Macau, and is an unregistered company for the purposes of the Companies Ordinance (Cap. 32) ("the Ordinance"). It has a wholly owned subsidiary registered in Hong Kong known as Zhu Kuan (Hong Kong) Company Limited ("ZK HK"). ZK Group and ZK HK are "window companies" for the Zhuhai Municipal Government ("the ZMG"). Since at least 1995, ZK Group and ZK HK have borrowed substantial funds from a number of banks to finance their operations and those of their subsidiaries. However, it appears that from about 1998 or 1999 onwards, there began to be defaults in the payment of installments of principal and interest as they fell due.

Between about September 2000 and about June 2003, negotiations between the creditors and ZK Group, but no agreement was reached in relation to the restructuring plan and repayment arrangement. In about June or July 2003, the creditors took steps to investigate the position in relation to the land. It was reported that two parcels of land belonging to ZK Group had been partially forfeited by the ZMG on 14 July 2003. This discovery caused the creditors great concern. Shortly after this discovery, SCB presented its petitions against ZK Group and ZK HK on 12 August 2003, and applied *ex parte* on notice the next day for the appointment of provisional liquidators in respect of ZK Group and ZK HK. Since their appointment, the provisional liquidators have tried to take steps to investigate the affairs and secure the assets of ZK Group and ZK HK.

Although ZK Group is not registered under the Ordinance, it may be wound up under the provisions of section 327 of the Ordinance. Further, given the lack of information as to ZK Group, and the apparent lack of cooperation from its former directors and officers, the Judge in the High Court thought that the Hong Kong court would inevitably feel bound to dismiss a winding up petition brought in Hong Kong in respect of ZK Group on the basis that a winding up in Macau would do just as well.

With respect to the powers of the provisional liquidators of ZK Group, the Judge also held that it should not be confined to ascertaining and taking possession of assets, books and records of ZKG in Hong Kong. In other words, the powers of provisional liquidator may include the collection of assets located in other jurisdictions, such as Macau, Mainland China. According to the relevant regulation, the exercise of this power by the liquidators may be limited in the Mainland China given the fact there is no such agreement between Hong Kong and Mainland.

V. Draft Enterprise Bankruptcy Law, Article 7

In the Draft Enterprises Bankruptcy Law of the PRC (2005), there is one specific article on cross-border insolvency. Article 7 states thusly:

"The bankruptcy proceedings opened by the People's Court under this law shall have effects on the assets of the debtor located outside of the territory of the PRC.

The bankruptcy proceeding opened outside the territory of the PRC, subject to the approval by the People's Court of China, may have effect on the assets of the debtor located within the territory of the P.R.C. In the case that the foreign proceeding falls into one of the following circumstances, the People's Court may make a decision which the foreign proceedings do not have effect on the assets of the debtor within the territory of the P.R.C :

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. The recognition of the foreign proceedings will be detrimental to the legitimate interests of Chinese creditors.

At first glance, this article generally adopts the universality principle since it talks of both extraterritorial effect of Chinese proceedings and intraterritorial effect of foreign proceedings. It experienced a long discussion prior to including these provisions in the draft since there are many diversified viewpoints in this regard both nationally and internationally. For instance, there have once been such varying theoretical arguments in China as territoriality, restricted territoriality, mutual recognition, and universality. Chinese current legislation remains unanswered to this issue but territoriality sometimes seems to be the dominant consideration in judicial practice. From an international perspective, although territoriality is historically the predominant philosophy endorsed by many States, modern trends indicate a strong and growing advocate towards universality. Thus in this sense, this provision may be hailed as a welcome progress, compared to relevant article in the 1995 draft.

But on second thoughts, it may be noted that the conditions on recognition of a foreign bankruptcy proceedings are strictly listed. In effect, it may be not easy for a foreign proceeding to obtain recognition in the PRC since one of the circumstances set out in this Article 7 is easily satisfied, particularly on its general clause—other considerations deemed necessary by the people's court. Therefore, it is by all means a matter of discretion for the people's court to decide whether to recognize a foreign proceeding or not. As regards the rational explanation behind this provision, it may be risky for China to stride forward too quickly with a view to its national conditions.

Another comment here goes to the criticism about limited words on this big topic. It is always this author's view that one article in any case could not cover the essential aspects on cross-border insolvency. It could be very difficult for this article to function in practice without material and operational supporting provisions. At least, there should be one specific chapter to deal with this topic. The classical texts in this field, UNCITRAL Model Law on Cross-Border Insolvency and EU Regulation on Insolvency Proceeding, which draw global attentions, both provide us with a clear illustration on how significant it is to devise a framework under which the courts in different jurisdictions could cooperate well. It is recommended that China should give every consideration to the possibility of incorporating the provisions contained within the Model Law into its future bankruptcy law. Hopefully, the Judicial Interpretation by the Supreme Court could achieve more improvements with respect to cross-border insolvency in the future.

VI. Conclusion

In its efforts to adapt itself to the WTO membership, as a critical tache, China needs to speed up reforms with regard to its legal system involving foreign elements. Cross-border insolvency at any rate should be one of the focuses of attention, given its role-playing in inspiring the confidence of foreign investors on this emerging market. It can be happily observed that there are recent improvements associated with Chinese cross-border insolvency reflecting from both judicial practice and pending legislation. But we should not neglect many issues remaining tough and unsolved to date, such as lack of a set of functional framework, unconcerted judicial practice, etc. To improve present status, it would be better to introduce such international initiatives as UNCITRAL Model Law into Chinese legislative consideration, e.g., for the Supreme Court to enact it in its future Judicial Interpretation.

Another observation is there are more and more economic and legal affiliations between Mainland China and Hong Kong SAR in recent decades, which requires far-reaching cooperation to achieve efficiency and fairness in managing cross-border insolvencies. Accordingly, perhaps in the short term it would be helpful for the Mainland to enter into trial schemes of cross-border insolvency cooperation with Hong Kong although it would be best for China to adopt a national solution in this regard.