Cross-border Insolvency Practice in Mainland China: Latest Developments and Trend

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Executive Summary

China's development over the four decades since Reform and Opening-Up was launched in 1978 is deeply entwined with the process of globalization. China[1] has benefited from and contributed to globalization through increasing cross-border flows of capital, goods and people. Most international companies have footprints in China, and Chinese companies have global trading, investment and financing. Consequently, when it comes to cross-border insolvency and restructuring, China inevitably is one of the main jurisdictions to focus on. The aim of this article is to share and analyze some key developments in China's cross-border insolvency regime and practice and outlines the future outlook.

Brief Introduction

The prime legislation governing China's insolvency regime is the ***Enterprise Bankruptcy Law***[2] promulgated on 27 August 2006 and came into force on 1 June 2007. Similar to many jurisdictions, China's insolvency regime encapsulates the following concepts:

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1 For the purpose of this article, China refers to the Mainland of the People's Republic of China, excluding the special administrative regions.
2 Please note that individual bankruptcy is still not recognized in China yet, and there is no regime for individuals to excuse themselves from liability for debts. There have been academic scholars and professionals working on the legislative proposal of personal bankruptcy for years, and it is expected that the individual bankruptcy regime will be put in place in the near future.

- Voluntary and involuntary liquidation, and ratable distribution
- Court-based insolvency proceedings and out-of-court mechanisms
- An independent administrator appointed by the court
- Moratorium
- Creditors involvement (creditors' meetings and creditors' committee)
- Court-led restructuring and settlement
- Voidable transactions during the asset recovery
- Extraterritoriality, allowing property outside China and certain foreign proceedings to fall within the regime

Article 5 of the *Enterprise Bankruptcy Law* is the foundation of the cross-border insolvency practice. It says:

Any insolvency proceeding that originates under this Law shall be binding on all assets that are held outside China by the debtor.

Where a foreign court's judgment or ruling on an insolvency case that has taken effect involves assets in China held by a debtor, and an application or request for judicial recognition and enforcement of the judgment is made to the Chinese court, the Chinese court shall, pursuant to the international treaty that China has concluded or is a member of, or pursuant to the principle of reciprocity, examine the application or request; where the Chinese court deems that the application or request will not violate the basic principles of Chinese law, threaten national sovereignty, security and public interest, and will not impair the lawful rights and interests of the creditors within China, the Chinese court shall make a ruling on recognition and enforcement.

After the law became effective in 2007, for almost 15 years, Article 5 recognition is still scarce for various (obvious and less obvious) reasons. However, there have been some significant improvements in the last 2-3 years, particularly last year.

Latest Developments and Practice

1. Development on Reciprocity (2018 & 2019)

Until now, no explicit rules has been laid down to interpret 'reciprocity' in practical terms. From a previous judicial practice point of view, Chinese courts interpreted reciprocity in a rather rigorous way. They assumed reciprocity did not exist unless and until there had been a Chinese judgment already recognized in that foreign country in the first place.

However, there has been a subtle but discernible change in courts' interpretation regarding reciprocity in recent years. In March 2018, the Chinese Supreme Court called for new approaches to apply the principle of reciprocity in the context of cross-border insolvencies[3]. Further, in December 2019[4], the Supreme Court

[3] Paragraph 49 of Minutes of the National Courts Conference on Insolvency Trials(《全国法院破产审判工作会议纪要》)
[4] Paragraph 24 of Supreme People's Court's Opinions on the People's Courts' Judicial Services in Support of the Belt and Road Initiative (2019) (最高人民法院关于人民法院进一步为"一带一路"建设提供司法服务和保障的意见(2019))

explicitly clarified the principle of presumed reciprocity, i.e. reciprocity could be presumed to exist if the requesting country has not declined to recognize the judgments from the requested country in the past.

2. The First Agreement in the Cross-border Insolvency Cooperation (2021)

On 14 May 2021, the Supreme Court of Mainland China and the Government of the Hong Kong Special Administrative Region ("HKSAR") signed the *Record of Meeting on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings* between the courts of the Mainland and the HKSAR ("Record of Meeting"). It launched a landmark co-operation mechanism for mutual recognition and assistance in insolvency proceedings ("Cooperation Mechanism").

According to the Supreme Court Opinion[5] drafted in the spirit of the Record of Meeting, a Hong Kong liquidator or provisional liquidator may apply to the Mainland courts of three pilot cities (namely Shanghai, Shenzhen and Xiamen) for recognition and assistance in insolvency proceedings where the debtor company's center of main interests ("COMI") is in the HKSAR for six (6) or more consecutive months at the time application is made.

The Cooperation Mechanism positions HKSAR as the first and only jurisdiction to have an established mechanism of mutual recognition and assistance in insolvency proceedings with Mainland China and marks a significant move of Mainland China in the cross-border insolvency regime. The Cooperation Mechanism gives foreign liquidators and creditors greater access to assets in Mainland China.

3. Cross-border Insolvency Proceedings Recognized in China (2021)

Prior to the Cooperation Mechanism between Mainland China and Hong Kong, there were only three reported overseas (Italian, French and German) insolvency cases[6] recognized by Chinese courts based on judicial assistance treaties on civil and commercial matters.

Not long after entering into the Cooperation Mechanism, the Shenzhen Intermediate People's Court (the "Shenzhen Court") received the first letter of request (Hong Kong to Mainland China) for the recognition of insolvency proceedings over Samson Paper Company Limited (In Creditors' Voluntary Liquidation) [2021] HKCFI 2151 from the Hong Kong High Court.

[5] The Supreme People's Court's Opinion on Taking Forward a Pilot Measure in relation to the Recognition of and Assistance to Insolvency Proceedings in the Hong Kong Special Administrative Region(《最高人民法院关于开展认可和协助香港特别行政区破产程序试点工作的意见》); For the courtesy English translation, please refer to: https://www.doj.gov.hk/en/mainland_and_macao/pdf/RRECCJ_opinion_en_tc.pdf

[6] In 2001, the Foshan Intermediate People's Court recognized the insolvency case of E. N. Group s.p.a. declared by the Milan Court, Italy;
In 2005, the Guangzhou Intermediate People's Court recognized the insolvency case of Pellis Corium Pelcor declared by the Commercial Court of Poitiers, France;
In 2012, the Wuhan Intermediate People's Court recognized the bankruptcy ruling of Dr. Koehler v. Seehaus rendered by the District Court of Montabaur, Germany.

In that case, Samson Paper Company Limited ("Samson HK") was resolved to be wound up by its shareholder. The liquidators identified its substantial assets in Mainland China, principally located in Shenzhen, and formed the view that they needed to obtain recognition and assistance to deal with those assets. On 20 July 2021, the Hong Kong High Court granted the liquidators' application for a letter of request to be issued to the Shenzhen Court seeking assistance in the liquidation of Samson HK.

After examining the case in accordance with the requirements set out in the Supreme Court Opinion, on 15 December 2021, the Shenzhen Court recognized, for the first time, the Hong Kong liquidation proceedings and allowed the liquidators of Samson HK to exercise various powers in Mainland China, including to manage and dispose of the company's assets.

The second application to seek recognition in Mainland China under the Cooperation Mechanism was recently made in the case of Zhaoheng Hydropower (Hong Kong) Limited (In Liquidation).

Historically, Hong Kong has played a critical role in acting as a stepping board for both international and Chinese companies to access each other's markets in terms of trading, investing and financing. In a cross-border insolvency setting, benefiting from the Cooperation Mechanism, it is foreseeable that Hong Kong can become a hub to facilitate international insolvency practice when there is a China element.

4. Chinese Insolvency Proceedings Recognized Overseas (2019 - 2021)

Given that China has been very much integrated into globalization, many distressed Chinese companies have abroad subsidiaries and assets. It is equally important to have Chinese proceedings recognized and assisted overseas. The following recent cases deserve some attention.

1) In re Reward Science and Tech. Industry Grp. Co, Ltd.

In October 2019, the U.S. Bankruptcy Court for the Southern District of New York recognized the reorganization proceedings of Reward Science and Tech. Industry Grp. Co, Ltd. ("Reward"), marking the second case in which a Chinese insolvency proceeding filed under Chapter 15 of the U.S. Bankruptcy Code was recognized. The U.S. Bankruptcy Court also gave Reward's foreign representative authority to administer the debtor's U.S.-based assets and to gather evidence in respect of Reward's liabilities, assets, business affairs, and operations in the U.S.; and granted a stay on any action concerning the Reward's assets in the U.S., including two litigation proceedings initiated by the dissented creditors.

This case evidenced the willingness of the U.S. to recognize Chinese insolvency proceedings.

2) Re CEFC Shanghai International Group Limited (in Liquidation in the Mainland of the People's Republic of China) [2020] HKCFI 167

In this case, the Hong Kong Court granted recognition and assistance for the first time to the administrators appointed for a company in insolvency proceedings in Mainland China. The Court also imposed a stay on all proceedings in Hong Kong against the company.

CEFC Shanghai International Group Limited ("CEFC[7]"), a Mainland China-incorporated conglomerate, went into insolvent liquidation and administrators were appointed. The primary reason for the administrators' application to the Hong Kong Court for recognition and assistance was to stay the garnishee order nisi which the creditor had made against CEFC's subsidiary in Hong Kong. The Hong Kong Court held that such stay should be imposed since it is consistent with the insolvency proceedings' universal application to ensure fairness between creditors.

3) Re HNA Group Co Limited [2021] HKCFI 2897

In September 2021, the Hong Kong Court made an unprecedented decision by recognizing the reorganization proceedings of the Hainan-based conglomerate[8], HNA Group Co., Limited (the "HNA"). The decision was made upon the first letter of request (Mainland China to Hong Kong) pursuant to the Cooperation Mechanism, demonstrating a further welcome and important development in cross-border insolvency co-operation between the Mainland and Hong Kong.

The decision of recognition and assistance made by the Hong Kong Court enabled administrators of the HNA to access and dispose of the company's assets in Hong Kong and progress the restructuring. Subsequently, in October 2021, the HNA's restructuring plan, involving US$170bn debt, where more than 300 group companies were revamped into four (4) entities, was approved by the Hainan Province High Court, marking the largest reorganization and restructuring case in China's history.

5. Foreign Creditors may more actively participate in the Chinese Insolvency Proceedings

In recent years, foreign creditors have been more actively participating in the restructuring of Chinese companies. And their rights have been duly recognized and better protected.

In an out-of-court restructuring, foreign investors may actively seize the opportunity to get paid on desirable terms. Taking the restructuring of Tewoo Group Co., Ltd. ("Tewoo Group")[9] for example, before stepping

[7] CEFC China Energy (Chinese: 中国华信能源) was a Chinese conglomerate. The company was among the 10 largest private companies in China in 2014. Since 2013 the company was listed on the Fortune Global 500 list holding the rank of 229 in June 2016. In 2019 - 2020, the company was declared insolvent as well as its subsidiaries CEFC Shanghai International and CEFC Hainan International. Later on it was found CEFC used a complex web of affiliated companies to facilitate sham deals, inflate trade figures and obtain bank loans to fuel its aggressive expansion.

[8] HNA was involved in numerous industries including aviation, real estate, financial services, tourism, logistics, and more. In July 2017, HNA Group ranked No. 170 in 2017 Fortune Global 500 list with a revenue of US$53.335 billion. It is one of the most active investment companies in the world, acquiring numerous assets under its name. In 2021, the corporation declared bankruptcy after debt restructuring efforts failed.

[9] Tewoo Group, established in 1992, operates as a state-owned Chinese company based in Tianjin and engaged in commodity trading, logistics and finance, real estate, etc. The company was listed on the Global 500 holding the rank of 132 in 2018. The company began to default on its bonds in March 2019.

into the court-led restructuring proceeding, in December 2019, Tewoo Group offered a debt restructuring plan to its foreign bondholders where the foreign bondholders may either agree to be paid between 36% and 66.73% of the bond value or to swap their debt for new bonds issued by a new issuer. Most offshore bondholders accepted the offer, avoiding a lengthy court-led restructuring process. In contrast, Tewoo Group's domestic creditors were compensated following a court-approved restructuring plan issued in December 2020, one more year later.

In the court-led insolvency proceedings, the administrators are appointed by the Chinese court either in a lottery-style random selection from the existing panelist or via a public bidding process. The latter one is more often used for high-value insolvency cases. The court began to accept the administrator candidate(s) jointly recommended by the debtor and creditors in recent judicial practice. In a very recent case, the foreign bank creditors, holding RMB 10 billion (c EUR 1.4 billion) credits accounting for almost 1/3 of the total bank credits, proactively participated in the recommendation and selection process of the administrator and ensured a competent administrator with credible international experiences was appointed to safeguard foreign creditors' interests are treated fairly.

6. Increased Certainty to Creditors holding Keepwell-backed Offshore Bonds

In recent years, China has seen a rise in the offshore corporate bond default rate. A number of onshore parent companies of the offshore subsidiary issuers are seeking to restructure and reorganize to address financial difficulties.

Notable common market practice for Chinese companies' offshore financing is that offshore corporate bonds carry a keepwell arrangement as credit enhancement, which is typically an undertaking of an onshore parent entity to ensure that the offshore issuer (subsidiary) will remain solvent and maintain a positive net worth. The rationale of the keepwell arrangement is to create some obligations on the onshore parent entities while circumventing the regulatory restriction that the mainland-incorporated companies shall not guarantee their subsidiaries' offshore debt without foreign exchange regulatory registration and approval which is ultimately due to China's currency control regime.

The keepwell arrangements are usually governed by laws other than Chinese law and subject to the exclusive jurisdiction of courts outside Mainland China (e.g., in Hong Kong).

In the context of insolvency, concerns about the enforceability of the keep-well arrangement in China were raised when the administrators of the Peking University Founder Group Corp. ("Founder Group[10]”) rejected the claims based on Founder Group's keepwell-backed bonds in August 2020. It is reported that the administrators' decision was made on the basis that the validity of keepwell arrangements had not been recognized in China.

[10] It is a major Chinese technology conglomerate that deals with information technology, pharmaceuticals, real estate, finance, and commodities trading.

A recent Chinese court decision[11] by the Shanghai Financial Court in late 2020 carries some favorable implications.

In July 2018, a holder of certain offshore bonds issued by a BVI subsidiary of CEFC commenced proceedings against CEFC at the Hong Kong Court for breach of the keepwell deed and obtained a default judgment (before CEFC being placed into insolvency liquidation in November 2019).

In May 2019, the bondholder applied to the Shanghai Financial Court to recognize and enforce the Hong Kong judgment. In November 2020, the Shanghai Financial Court decided to recognize the Hong Kong judgment pursuant to the *Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters* between the Courts of the Mainland and the HKSAR in accordance with the *Choice of Court Agreements between Parties Concerned* (the "Shanghai Judgement").

The Shanghai Judgment demonstrates a viable path for offshore creditors' relief under keepwell agreements/deeds or similar arrangements (e.g. comfort letter). Foreign law is the governing law, and the jurisdiction is outside Mainland China. After a favorable judgment or arbitration award has been obtained offshore, a Chinese court is likely to grant recognition and enforcement on the basis of reciprocity, bilateral agreements or the New York Convention.

Correspondingly, a recent Hong Kong court ruling[12] in 2021 is noteworthy.

After the claim that Founder Group had defaulted on its obligations under the keepwell deeds was rejected by the Chinese administrators of Founder Group, the issuers (in liquidation in the BVI) and guarantors of certain bonds backed by keepwell arrangements with Founder Group commenced proceedings against Founder Group in Hong Kong ("HK Actions"). The issuers and guarantors applied for an expedited trial of the HK Actions and a declaration of their rights as a matter of English law. In response, Founder Group applied to stay the HK Actions. The Hong Kong court held the HK Actions would not be stayed, the offshore bondholders' rights under the keepwell deeds should be determined in Hong Kong in accordance with the contractual exclusive jurisdiction clause, notwithstanding the HK court recognizing the keepwell provider's Mainland insolvency proceedings and providing the administrator various forms of assistance.

7. Out-of-Court Restructurings

In recent years, due to China's deleveraging strategy, structural adjustments and increasingly strict industrial regulatory restrictions, coupled with the impacts of the COVID-19 pandemic, the growth of what were once highly profitable industries, particularly the real estate sector, has been constrained. Many companies caught in debt crisis seek out-of-court debt restructuring rescue plans to avoid going into rigid court-led administration.

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[11] Case of the application by Right Time Global Investment SPC-Right Time Value Investment Fund for recognition and enforcement of a civil judgment of a court of the Hong Kong Special Administrative Region

[12] Nuoxi Capital Ltd (In Liquidation in the British Virgin Islands) v Peking University Founder Group Co Ltd [2021] HKCFI 3817

Although the *Enterprise Bankruptcy Law* lays down a framework for restructuring and settlement within the formal insolvency process, companies can adopt informal measures not involving the court. Informal out-of-court restructurings offer relevant parties greater control of the rescue plan, though, same as most commercial deals, they are not successful all the time.

Reference can be made to the following three prominent Chinese real estate restructuring cases last year.

a. China Fortune Land Development ("CFLD")[13] was the first Chinese property developer to suffer from a repayment failure since China's deleveraging policy measures for the property sector were issued in 2021. In February 2021, the Financial Institution Creditors Committee (the "Creditors Committee") was set up to resolve CFLD's distress. In October 2021, CFLD released a restructuring plan to dispose of around RMB 219.2 billion (c EUR 31.7 billion) of debt through asset sales, debt-to-equity swaps, divestitures, debt renewal or extension and offset by beneficial rights in the trust. In December 2021, CFLD announced that the Creditors Committee approved the restructuring plan, and CFLD was negotiating with the creditors on the restructuring agreements to be signed. In its latest announcement dated 10 February 2022, around RMB 42.92 billion (c EUR 6.2 billion) of debt had been restructured under the plan with RMB 2.87 billion (c EUR 415 million) of debt interest and penalty waived.

b. China Evergrande Group ("Evergrande"), the world's most indebted real estate developer, missed debt payments starting on September 2021. On 6 December 2021, Evergrande launched a risk management committee (the "Risk Committee") with most seats held by representatives of state-owned companies in Guangdong province to monitor and mitigate future risks. On 26 January 2022, Evergrande announced that it aimed to have a preliminary restructuring proposal in place within six (6) months. Very little concrete information about the developer's restructuring had been provided in its official statements. Some international bondholders of Evergrande have warned of legal action against the developer due to its lack of substantial engagement and transparency on its plans.

c. Kaisa Group Holdings Limited ("Kaisa"), the second-most indebted offshore bond issuer behind Evergrande in the Chinese property sector, has been taking various measures to address its liquidity problems and avoid bonds default. According to Kaisa's official statements and announcements, these measures include soliciting investors' opinions to develop a more feasible payment plan, speeding up the disposal of high-quality assets in Shenzhen, Shanghai and other places, withdrawing funds to redeem wealth products etc. Kaisa's offshore creditors have proposed to buy the developer's non-performing loans from Mainland Chinese banks to prevent the onshore creditors from liquidating the developer's assets, directing funds towards Kaisa's premium projects stalled on the Mainland gaining more information about Kaisa's onshore restructuring process.

[13] It is a publicly traded Chinese real estate developer focused on industrial parks. Since June 2017, it’s part of Shanghai Stock Exchange's blue chip index: SSE 50 Index.

8. More Distressed Investing Opportunities for Foreign Investors

China's distressed asset industry has an increasing appeal to foreign investors from a market perspective and at regulation and policy levels. From 2018 to 2020, we witnessed relevant Chinese regulators removed the foreign shareholding ratio restriction in asset management companies ("AMC"). Furthermore, they encouraged and attracted internationally renowned distressed-investing financial firms to enter the China market when high-yield real estate defaults were on the rise. Leading international investors with distressed investing specialties such as Oaktree Capital[14] and Warburg Pincus[15] made significant commitments to the China bad debt market last year. Once duly licensed, foreign firms can directly acquire non-performing loans[16] from Chinese banks.

Future Outlook

- In late 2020, the Chinese legislature decided to include the revision of the *Enterprise Bankruptcy Law (2006)* in its 2021 legislative work plan[17]. In August 2021, the enforcement inspection unit of the legislative body reported its investigation and research on the implementation of the *Enterprise Bankruptcy Law* and related rules[18]. The urgent need for detailed rules on handling cross-border insolvency has been duly recognized. It is expected that cross-border insolvency rules will be further improved in the near future.

- The Cooperation Mechanism indicated China's efforts to deepen international cooperation further. It may be interpreted as part of China's domestic strategy in improving the insolvency co-operation with Hong Kong. Whether this precedent will spark a new era of bilateral insolvency protocols between mainland China and other countries remains to be seen.

- China's economic downward pressure is significant in the backdrop of global economic disruption and the likely recession. Domestically, the tightening control on the financing in certain industries, if not relaxed materially, might make it inevitable that more Chinese companies will be caught in the debt crisis. They will seek to use the restructuring and insolvency regime as a tool to rehabilitate its business or to withdraw from the market. This trend certainly poses challenges to domestic and foreign creditors while creating opportunities for investors to buy distressed business/assets at a bargain price with clean title and most likely without any pre-existing security interests.

[14] https://www.scmp.com/business/banking-finance/article/3156265/us-distressed-investor-oaktree-capital-raises-us16-billion
[15] https://www.reuters.com/article/us-china-property-finance-idUSKCN2EB0Q3
[16] According to the China Financial Stability Report (2021) issued by the Chinese central bank, by the end of 2020, the outstanding non-performing bank loans reached RMB 3.47 trillion yuan, an increase of RMB 281.6 billion on a year-on-year basis.
[17] http://www.npc.gov.cn/npc/c30834/202104/1968af4c85c246069ef3e8ab36f58d0c.shtml
[18] http://www.npc.gov.cn/npc/kgfb/202108/0cf4f41b72fe4ddeb3d536dfe3103eb3.shtml

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