

China's legislature passed new Enterprise Bankruptcy Law

In brief

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- Alternatives for debtors, creditors and shareholders to deal with problem debts
- Cross-border insolvency regulations
- Better protection for creditors

Relevant regulations discussed in this issue:

PRC Enterprise Bankruptcy Law, adopted by the Standing Committee of the National People's Congress on 27 August 2006, will take effect on 1 June 2007 and apply to a wide range of entities

PRC Enterprise Bankruptcy Law (Trial Implementation), adopted by the Standing Committee of the National People's Congress on 2 December 1986 (to be superseded on 1 June 2007) had applied only to State-Owned Enterprises

The Standing Committee of the National People's Congress adopted a new PRC Enterprise Bankruptcy Law on 27 August 2006, which will take effect on 1 June 2007. It will supersede the existing bankruptcy law, which was adopted in 1986 and ran on a trial basis for more than two decades. The new law provides for a more orderly and structured approach to deal with failing companies and seeks to provide better protection for creditors.

It is generally hoped that the new law will play its part in promoting China's economic development by encouraging investors and creditors to further invest and extend credit in China.

Unified insolvency regime applicable to a wide range of entities

- The new law applies to all types of enterprises including state-owned enterprises, foreign investment enterprises and privately-owned enterprises.
- Regulatory authorities will have sole responsibility to take trusteeship or initiate bankruptcy proceedings against insolvent financial institutions such as commercial banks, securities and insurance companies.
- Individuals, sole proprietors and partnerships are not covered by the new law. Although it had been intended to include them at the drafting stage, they were eventually excluded due to the complexities and uniqueness of such bankruptcies.

Enterprise Bankruptcy Law

The method of reorganisation to be applied conforms to most modern global restructuring and insolvency regimes and can offer creditors a better recovery than in a liquidation scenario

Formal restructurings instigated by the debtor, and in the form of the reconciliation are not normally seen in practice but advocates argue that it is consistent with Chinese Civil Law and should therefore play a role in resolving bankruptcy

Despite the introduction of the new restructuring laws, bankruptcy is expected to remain the most common type of insolvency proceeding in China

Alternatives for debtors, creditors and shareholders to deal with problem debts

- Reorganisation

A formal debt restructuring supervised by the Court, under which a compromise is sought between the debtor, its creditors and its shareholders:

- A creditor, the debtor, or any of its shareholders holding not less than 10 percent of its equity may apply to the court to seek a "reorganisation ruling" once a petition to bankrupt the debtor has been filed, but prior to the issuing of the bankruptcy declaration.
- Under the reorganisation ruling, the debtor and creditors will have a six-month period (may be extended to nine months subject to court approval) to agree on a reorganisation plan.
- During this period, secured creditors cannot seize and dispose of the debtor's secured assets. The debtor is provided an opportunity to negotiate a reorganisation of debt with its creditors without the interruption of creditors to its operations.
- In the event that a reorganisation plan is agreed by the creditors at a creditors meeting (at least 50 percent of the creditors by number and two thirds of the total amount of outstanding debt) and approved by the court, a court-appointed administrator will supervise execution of the plan.

- Reconciliation

This is also a form of a formal debt restructuring that can be instigated by the debtor before or after a petition for bankruptcy:

- A debtor can apply to the court to obtain a ruling on debt reconciliation with unsecured creditors.
- There is no statutory time limit to prepare or agree on the reconciliation agreement.
- The reconciliation agreement must be agreed by the unsecured creditors at a creditors meeting (at least 50 percent of the creditors by number and two thirds of the total amount of outstanding debt) and approved by the court.
- Secured creditors are unaffected by the reconciliation and may continue to seize and dispose of the debtor's secured assets during the process.

- Bankruptcy

- The court will declare the debtor bankrupt if there is failure to reach an agreement on a reorganisation or reconciliation.
- The debtor will be liquidated and proceeds from the debtors' assets will be distributed to all creditors according to their rank in priority.

Enterprise Bankruptcy Law

Inclusion of provisions for cross-border insolvency is another step taken to align China with the growing international practice of respecting foreign bankruptcy judgments

Application of secured assets to payoff employees have long been severely criticised by the market. The change brought about by the new law will hopefully restore market sentiment

The GITIC chairman committee comprising 9 major creditors was the first ever creditors' committee in China

This is another change to move in line with international practice

Cross-border insolvency regulations

- The new law requires the administrator to seek the recovery of overseas assets of a bankrupt enterprise.
- The new law provides recognition of bankruptcy proceedings initiated in a foreign jurisdiction for the purpose of enforcing orders against assets subject to a bankruptcy order and located in China. Liquidators of foreign bankrupt companies may file a petition in Chinese courts for a ruling to seize bankruptcy assets located in China provided the following conditions are met:
 - The jurisdiction of the bankrupt estate has a reciprocity treaty with China.
 - The bankruptcy proceedings do not violate China's sovereignty rights, social security and public interests, and do not impair the legal interests and rights of Chinese creditors.

Better protection to creditors

- The new law will bring an end to the current practice of applying secured assets to satisfy employees' claims ahead of secured lenders. The last group of employees of bankrupt companies capable of taking advantage of the current practice will be those who are owed salaries, social insurance and related amounts up to the day before the new law was passed on 27 August 2006.
- The new law facilitates the option of setting up a creditors' committee comprising a maximum number of 9 members, one of which must be selected from the bankrupt's employees. The rights conferred on the committee surrounds supervising the management and disposition of bankruptcy assets and are generally viewed positively as it provides transparency to the bankruptcy process.
- The new law introduces the role of an administrator to manage the bankruptcy process. It can be a liquidation committee comprising relevant government officials; or professional accountancy, legal or related social intermediary firms. The right to appoint the administrator rests with the Court but creditors may replace the administrator if it is deemed to have failed to perform its duties.
- Creditors under the existing bankruptcy law must register their claims within three months of the date of announcement of bankruptcy. Late registration will not be accepted. The new law provides for registration of claims at any time before the final distribution of the bankrupt's assets. However, such creditors will have no right to participate in distributions made prior to their registration and adjudication.

Contact us

For more information on these new measures and how they will affect you or your company, please contact:

China

Jannie Wong
Tel. +86 (20) 8331 8155
jannie.wong@kpmg.com.hk

Hong Kong

Jacky Muk
Tel. +852 3121 9803
jacky.muk@kpmg.com.hk

The new law has adopted a number of international practices. A number of these practices have been deployed in the liquidation of Guangdong International Trust & Investment Corporation (GITIC). KPMG was engaged by the GITIC liquidation committee appointed by the Guangdong People's Higher Court to act as the financial adviser.

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