KPMG

China

Applicable PRC Bankruptcy laws until the introduction of the new PRC Enterprise Bankruptcy Law which will have effect from 1 June 2007

Introduction

For cultural reasons, the concept of formal bankruptcy law is a relatively new one in China. There were sparse regional laws on business bankruptcy from about 1900 which were seldom used. From 1949 to the early 1980s, business enterprises never went bankrupt since no such concept existed under a Communist regime, where a majority of the enterprises were State-owned Enterprises ('SoEs'). Following the opening up of the economy of the People's Republic of China ('PRC') from the late 1970s and a gradual modification of the State-planned economy to a socialist market economy, and with the eventual formulation of non-State-owned business enterprises, business failures have begun to occur as a result of competition and market operations. This has led to the introduction of a number of business laws, and rules and regulations including those relating to bankruptcy and liquidation.

Bankruptcy, used in the corporate sense, refers to the winding up of insolvent business enterprises. This process requires heavy involvement and supervision from the relevant court. Liquidation, on the other hand, refers to the winding up and dissolution of solvent business enterprises and no court involvement is required.

There is as yet no insolvency law to deal with receiverships or the bankruptcy of individuals.

Legislation

National

The first national bankruptcy legislation was targeted for SoEs. It was promulgated in 1986 and was put into effect as 'trial implementation' in 1988. Provisions for bankruptcy and/or liquidation are now contained in the following national laws (effective dates in brackets):

- Bankruptcy Law for State-owned Enterprises (November 1988);
- Chapter 19 of the Civil Procedure Law (April 1991);
- Chapter 8 of the Company Law (July 1994).

Provincial or regional bankruptcy and liquidation laws, rules and regulations, initially to deal with mainly foreign-related business operations, have also been enacted. The major ones are set out below. In addition, any foreign investment enterprise wishing to be liquidated is also required to observe 'Liquidation Procedures for Foreign Investment Enterprises' issued by the Ministry of Foreign Trade and Economic Cooperation in 1996 and approved by the State Council in the same year.

Shenzhen

- Bankruptcy Regulations for Enterprises (November 1993).

Beijing

- Liquidation Measures for Foreign Investment Enterprises (June 1992);

- Dissolution of Foreign Investment Enterprises (July 1995).

Guangdong Province

- Bankruptcy of Companies (August 1993).

Application of laws

Although the underlying procedures and mechanisms under the various national and regional laws are not completely dissimilar, there are marked differences in how the laws are to be implemented locally. Further, it is pertinent to know of the exact legal status of the entity in question as different laws apply to different types of business enterprises even within the same region.

Insolvency procedures

Bankruptcy procedures

The following general procedures are drawn from the 1988 bankruptcy legislation for SoEs and chapter 19 of the Civil Procedure Law. They apply in practice to both State-owned and non-State-owned enterprises in areas like filing of a bankruptcy application, notice to creditors, public announcement of bankruptcy applications, composition of bankruptcy committees and creditors' meetings.

Application for bankruptcy

An application may be made to the relevant court by a creditor with evidence in respect of the inability of the debtor to repay the debt and stating details of any security held. A debtor may itself apply for bankruptcy. Explanations are required as to the circumstances and reasons for the losses incurred. A statement of account together with a list of its debts and claims is also required. In the case of an SoE, approval from its direct 'supervising' body is needed.

Within seven days of receiving the application, the court must decide on whether to admit the case for hearing or otherwise. If the case is admitted for hearing, the court is required, within 10 days, to make a public announcement of the admission of the bankruptcy application and notify the debtor. Where an application for bankruptcy is made by a creditor, the debtor is required to submit to the court a list of its debts and claims within 15 days of receipt of the notification from the court.

Within 10 days of receipt of the list of debts and claims the court will notify all known creditors.

Creditors who receive notification from the court must report their claims, whether secured or not, to the court within one month. All other creditors are required to submit their claim within three months from the date of the public announcement. Any creditor who fails to report to the court within the specified time limit will be deemed to have abandoned his claim.

Both the public announcement of the admission of the bankruptcy application and the notice to known creditors must contain the date and venue of the first creditors' meeting. The law requires the court to call the first creditors' meeting within 15 days after the expiration of the period allowed for reporting claims, to report on and consider the financial circumstances of the debtor.

Reorganisation proposal

Where the court has admitted an application for bankruptcy filed by a creditor, the debtor, or in the case of an SoE, the supervising body, may within three months of the court's acceptance of the bankruptcy application, submit to the court, a proposal for reorganisation. Such proposals must include plans for rehabilitation of the business no longer than a period of two years and debt repayment.

The bankruptcy proceedings will be suspended by the court if the proposal is adopted at a creditors' meeting and a meeting attended by representatives of employees.

Supervision of the reorganisation plan is by a committee of the creditors and the employees. In the case of an SoE, the supervision is by the original supervising body. Reports on progress are made to creditors regularly.

The reorganisation plan may be suspended by the court if the debtor has carried out activities contrary to the interest of the creditors, or where the debtor's financial position continues to deteriorate during the reorganisation period.

The court will terminate the bankruptcy proceedings upon the successful completion of the plan.

The position of a creditor

A creditor may exercise his rights generally through a creditors' meeting. A secured creditor may participate in a creditors' meeting without the right to vote unless the security is surrendered.

The functions of a creditors' meeting include the following:

- to adjudicate claims received;
- to discuss and adopt any reorganisation plan submitted; and
- to discuss and adopt any plans to deal with and distribute the assets in the bankruptcy proceedings.

Resolutions at a creditors' meeting are only adopted when passed by a majority, in number, of the creditors present and voting at the meeting, and the claims represented by such creditors must exceed 50 per cent of the total claims admitted. However, resolutions in connection with reorganisation proposals must be passed by creditors representing more than two thirds of the total claims admitted. All resolutions passed are binding on all creditors.

Either the court, the chairman of the creditors' meetings, the bankruptcy committee (in the course of formal bankruptcy) or creditors representing at least 25 per cent of the total claims admitted may propose to hold a creditors' meeting.

Bankruptcy proceedings

The court may declare a business enterprise bankrupt under the following circumstances:

- where there are substantial business losses and matured debts cannot be settled;
- where no reorganisation plan is approved; and
- where any approved reorganisation plan fails.

Within 15 days of declaring the debtor bankrupt, the court should establish a bankruptcy committee to take over the business and assets of the debtor. The bankruptcy committee handles the winding up of the affairs of the debtor and reports to the court.

Members of the bankruptcy committee are appointed by the court from amongst the relevant 'supervisory body' (where SoEs are involved), the local government financial agencies, other relevant government departments and professionals. The bankruptcy committee may engage professionals such as lawyers and accountants to assist with their work.

The bankruptcy committee may apply to the court to declare invalid the transactions which took place within six months prior to the application for bankruptcy, such as transfers of property at undervalue or preference of selected creditors.

All bankruptcy expenses are discharged from assets available in the bankruptcy proceedings before making payments in the following order of priority:

- employees' wages and labour insurance dues;
- taxes due;
- claims in the bankruptcy proceedings generally.

A plan to make any payment in the bankruptcy proceedings by the bankruptcy committee must be approved by a meeting of the creditors and then sanctioned by the court.

If funds are not sufficient to cover bankruptcy expenses, the court is required to terminate the bankruptcy proceedings. If assets are not sufficient to cover payment of any class of the claims in full, payment within that class is made on a pro rata basis.

The court will terminate the bankruptcy proceedings after payment of all funds as approved.

In bankruptcy cases involving SoEs, the relevant government departments will investigate the causes for the business failure of the SoE concerned. The officers responsible for its management, including those from its 'supervising body', may be subject to administrative admonishment. Criminal prosecution may also result where appropriate.

Liquidation procedures

The following liquidation and dissolution procedures are extracted from chapter 8 of the Companies Law and only apply to two types of legal entities in the PRC, namely, limited liability companies ('LLCs') and companies limited by shares ('CLSs'). Procedures for bankruptcy of LLCs and CLSs follow closely those set out in the 1988 bankruptcy legislation for SoEs and chapter 19 of the Civil Procedure Law.

A company may be liquidated and dissolved when:

- the operating period specified in the company's articles of association expires;
- the circumstances for dissolution as specified in the company's articles of association airse; or
- the shareholders resolve at a meeting to liquidate and dissolve the company.

A liquidation committee should be formed within 15 days of the occurrence of any of the above events triggering a liquidation process. In the case of LLCs, the liquidation committee is composed of its shareholders or their representatives and in the case of CLSs, the composition is decided upon by

the shareholders at a general meeting. If no liquidation committee is formed within the time limit, creditors may apply to the court to designate relevant persons to form a liquidation committee.

The liquidation committee is responsible for winding up the affairs of the enterprise; they may engage relevant professionals to assist with their work.

The liquidation committee must notify all known creditors within 10 days from their appointment and, within 60 days, make at least three announcements in newspapers of the liquidation. Creditors must within 30 days of receiving notice or within 90 days from the date of first announcement declare and register with the liquidation committee their claims together with supporting documentation.

The liquidation committee must register all claims, prepare a set of liquidation accounts and formulate a liquidation plan for confirmation by the shareholders.

Should the liquidation committee discover that a company being liquidated is unable to pay its debts in full, it should apply to the court for a declaration of bankruptcy and turn over the liquidation to the court.

When the liquidation is completed, the liquidation committee should prepare a liquidation report and submit it for confirmation by the shareholders. The report is also required by the relevant Business and Industry Registration Office for cancellation of the company's registration.

If members of a liquidation committee should cause the company or its creditors to suffer any loss in the liquidation process, they are liable to make the necessary compensation.

Notice

The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date is received or that it will continue to be accurate in the future. No one should act upon such information without appropriate professional advice a thorough examination of the particular situation.