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China's Enterprise Bankruptcy Law: Can it help overseas financiers recover their debts?

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There is little doubt that the financial turmoil and economic slowdown in global markets since the second half of 2008 has taken its toll on many businesses, especially those operating in overseas markets such as the United States and Europe. For companies in China, dependent on trade with these markets, weakened global demand for consumer products is now resulting in factory closures and distressed situations. Against a backdrop of tightened credit, many overseas financiers who eagerly entered the Chinese market in recent years are now faced with the realities of divesting themselves of problematic interests in China.

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In this article, PricewaterhouseCoopers[1] explore the implementation of China's Enterprise Bankruptcy Law (EBL) – a subjectthat is under the spotlight in this environment – to determine whether it can offer a remedy to overseas lenders looking to recover their debts in China.

China's Enterprise Bankruptcy Law

The adoption of the EBL, which came into effect on 1 June 2007, heralded the start of a new bankruptcy regime in China – part of the country's attempts to align with international best practice. For foreign parties investing in China, the EBL has been welcomed as a defined mechanism for dealing with problem investments by means of insolvency or restructuring proceedings.

In addition to allowing the appointment of an administrator to take control of a bankrupt entity's affairs, the EBL has significantly broadened the role of creditors, by providing, among other things, a mechanism for them to place debtor companies into bankruptcy or reorganisation (where the debtor can rehabilitate its business).

The reorganisation provision recognises the value that a restructuring can bring over and above a liquidation, and as such is considered to be a beneficial addition to China's bankruptcy regime. Under the EBL, a number of distressed companies with viable future prospects have already been successfully rescued.

During the reorganisation period, secured creditors' rights over assets pledged to them are temporarily suspended. This enables a debtor to execute a reorganisation plan (approved by creditors and the People's Court), and work towards rehabilitating its business in an attempt to emerge from bankruptcy with a clean slate.

The provision for restructuring under the EBL highlights the absence in Hong Kong of a comparable rescue regime and moratorium on creditor action. (See box 'Potential Hong Kong rescue regime').

1 "PricewaterhouseCoopers" refers to the network of member firms of PricewaterhouseCoopers International Limited, each of which is a separate and independent legal entity.

Potential Hong Kong rescue regime

Hong Kong currently has no corporate rescue legislation similar to the United States' Chapter 11 business rehabilitation regime and the United Kingdom's administration proceedings. During the 1998 financial crisis there was wide support for the introduction of such a regime. In 2001, the Companies (Corporate Rescue) Bill 2001 was released – however, it was not enacted due mainly to unresolved issues over whether funds should be set aside for employee entitlements. The present financial crisis has led to a new interest in corporate rescue legislation in Hong Kong. The Chief Executive recently announced that 'The financial tsunami presents an opportunity for all parties concerned to strike a compromise, and resume the necessary legislative work, so as to minimise business closures and job losses.'

Whether Hong Kong moves ahead with the introduction of such a regime – and, if so, how long it might take – remains to be seen.

The EBL applies to all kinds of insolvent entities, including private and state-owned enterprises and Foreign Investment Enterprises. Provided, therefore, that the insolvent debtor entities have assets, the EBL should technically offer avenues for foreign creditors to recoup their debts. But does it?

Uncertainties in practice

Although the EBL has been in place for nearly two years, there are still uncertainties over the interpretation and implementation of the law, which may be of concern to foreign lenders and deter their recourse to the EBL for recovering debts.

We discuss three of these practical issues below: (i) how foreign bankruptcy orders and foreign lenders will be treated; (ii) debtor-in-possession financing; and (iii) experience of the judiciary and administrators, all of which are considered to be significant in the practical implementation of the law. Precedents from successful bankruptcy cases will be needed to create more confidence for overseas financiers. The jury is still out on how long it will be until this level of comfort is achieved.

(i) How will foreign bankruptcy orders and foreign creditors be treated?

There are areas of uncertainty in the application of the EBL surrounding cross-border insolvencies and the treatment of foreign creditors. The EBL will recognise overseas bankruptcy proceedings covering assets in China, as long as reciprocal treaties exist between China and the respective foreign countries. However, the cross-border insolvency provisions in the EBL are brief and qualified by broad caveats stating that foreign bankruptcy orders will only be recognised provided:

- China's sovereignty, security and social and public interests are not impaired; and
- the legitimate rights of creditors in China are not impaired.

What this means precisely for offshore proceedings is not known, since the provisions have yet to be sufficiently tested by cross-border cases.

An uncertainty for foreign creditors generally is whether their claims will be seen as equal to those of domestic creditors. The EBL is silent on this point.

The FerroChina case – which involves offshore and onshore debt – is being viewed as a landmark test case for the EBL, the outcome of which will be of interest to a wide audience.

(ii) Debtor-in-possession financing

Another grey area in the legislation concerns the possibility of arranging debtor-in-possession financing during reorganisation.

A reorganisation under the EBL allows a debtor to manage its business ('be in possession') under the supervision of the administrator, if the court agrees. The debtor can pledge assets during a reorganisation in order to borrow additional funds needed to support its operations. In some jurisdictions, such as the US, 'super priority' is afforded to this new lending, known as debtor-in-possession financing, placing such creditors ahead of ordinary creditors.

The EBL alludes to the possibility of debtor-in-possession financing. However, whether it can be done in practice is uncertain. Further clarification from the Court would alleviate possible uncertainty over priority. This could encourage more recourse to debtor financing in a reorganisation and generate a better outcome for all stakeholders.

(iii) Experience of the judiciary and the administrators

Under the EBL, the court has a critical role and significant power to influence the outcome of insolvency proceedings, notwithstanding the fact that administrators and creditors also participate in the process. The extent to which best practices are adopted can vary case by case, depending on the individual judge's knowledge, experience and approach. In practice, government policies may also influence the court's handling of bankruptcy cases.

The effectiveness of the EBL is also closely tied to the technical competence and experience of the administrators overseeing the bankruptcy cases. At this juncture, administrators in China are relatively inexperienced in dealing with large and complex situations, particularly those involving foreign debts.

Under the EBL, administrators are appointed openly and randomly by rotation from local registers. In complex cases, administrators may be appointed by way of open tender. However, how this works in practice is unclear. Creditors may therefore have little – if any – say on which administrators are selected to administer the debtor's bankruptcy. By comparison with common international practices that overseas financiers are familiar with, the process may be seen as less fair, since it can result in the appointment of administrators that add little value to proceedings. This could deter foreign creditors from recourse to bankruptcy in China.

As more cases unfold, precedents will inevitably be set from the experience gained and the practical issues encountered. Eventually the Court is likely to issue implementation guidance notes setting out the rules and interpretations that will help standardise the implementation of the EBL.

Foreign lending structure

In parallel to the practical application of the EBL, the structuring of lending to China-based businesses is a key issue when financiers seek to recover value.

Where offshore funding is structured as a direct loan to the onshore company, it can enable the offshore lender to take security onshore and therefore participate in an EBL bankruptcy. However, the majority of foreign investment in China has taken the form of offshore lending to an offshore borrower, typically through a Hong Kong holding company. Proceeds are often brought into the joint venture or Wholly Foreign Owned Enterprise in China via equity.

In recent times, China has been awash with pre-IPO financing and leveraged structures, such as convertible bonds and preference shares, where the debt is offshore and the assets in China. With borrowers defaulting on debts and IPOs on the decrease, such lenders may lose their exit routes. Without any security onshore, they rank as equity holders below creditors, and have no prospect of returns in a bankruptcy if the debtor is insolvent. Offshore lenders in these situations face challenges of debt recovery due to limited enforcement rights and control over onshore assets as they seek to exit China.

What the future holds

Whether this situation prompts a revisiting of financing structures by offshore lenders and Chinese policy remains to be seen. Presently, one of the main drivers for how offshore funding is structured is Chinese regulation. The country's foreign exchange regulations limit the ratio of foreign debt a company in China can hold relative to equity. If foreign lenders were to bring some funds onshore as shareholder loans – at least up to the maximum permissible limits – as opposed to solely equity, then they would be able to enjoy some rights to participate in a bankruptcy.

The extent to which Chinese policy relaxes the regulations governing financing structures may well be driven by the country's need for foreign capital in the future.

How the EBL gets implemented in the current environment, and to what extent offshore creditors recover debts, will be of great interest to foreign investors. So too will be the issue of whether overseas lenders manage to extricate themselves from China without thwarting their chances of later re-entry, when the bullish environment for investing eventually returns.

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