



Bankruptcy: A way to restructure your business in bad times.

By **John Lee**, Attorney (Beijing) & **Matthew McKee**, Foreign Legal Counsel (Beijing)

Introduction

In these tumultuous economic times bankruptcy and corporate reorganisation are at the forefront of the public consciousness. There is a tendency to view bankruptcy from a negative perspective; the common idea of bankruptcy is that it means the end of the life of a company. Bankruptcy practitioners recognise that bankruptcy laws provide more than just the means to liquidate a company. Modern bankruptcy laws focus on reviving enterprises that have failed or have lost their ability to service their obligations. Similarly, systems of reconciliation and reorganization play an important role in China's Bankruptcy law. This briefing paper examines how companies can utilize China's bankruptcy laws to their advantage to ensure they survive these difficult times.

Why go bankrupt?

After registration of a bankruptcy petition, a debtor can apply to the court for reorganisation of the bankrupt company. This period of reorganisation may provide the company with sufficient time to meet and satisfy its obligations. This extra time may provide the company the opportunity to remove unprofitable aspects of its business and focus on the areas that are most profitable. A further option for the company is reconciliation with its creditors – this is where the unsecured creditors compromise on their claim with the company. Each of these mechanisms are an opportunity for otherwise profitable companies to continue to trade through bad economic times.

When can an enterprise file for bankruptcy?

An enterprise may file a petition for bankruptcy only if it meets two tests of insolvency as stated in Article 2 of the Bankruptcy Law: first, the debtor is unable to pay its debts when due (the “cash flow test”); and second, the debtor lacks sufficient assets to pay the debts (the “balance sheet test”). **Both** of these tests need to be satisfied before a bankruptcy petition will be accepted by the court.

What are the steps in applying for bankruptcy?

1. The first step in applying for bankruptcy is the consent of the shareholders. Without the consent of the shareholders, a debtor's petition will be rejected.

2. The company then needs to engage an authorized agency to audit the finance and assets of the enterprise. This step is required to establish that the enterprise has satisfied the requirements of insolvency.
3. The company shall then propose a scheme concerning the bankruptcy-----it shall appropriately arrange for the reemployment of the staff and workers of bankrupt enterprises, and shall guarantee their basic living needs prior to reemployment; specific measures shall be separately stipulated by the State Council (see Article 4)
4. The company then submits the application materials to the court with authority of jurisdiction.

What documents are required for a bankruptcy petition?

According to Article 8 of the Bankruptcy Law, the applicant has to file the following information:

1. The basic information of the applicant and that of whom an application is filed against;
2. The purpose of the application;
3. The facts and reasons for the application;
4. Any other matters that the People's Court considers ought to be included.

In the bankruptcy application, the company needs to “explain the circumstances of the enterprise's losses and deliver relevant accounting statements, a detailed list of debts and a detailed list of claims”(Article 8).

If the court accept the petition by a creditor, within 15 days of the registration of the petition, the materials shall be submitted as the company's financial status, a list of creditors, a list of debtors, relevant financial reports, the details of employees of the enterprises and the settlement proposal and the status of the payment of wages of employees and social insurance premium (Article 15).

Upon the acceptance of the application, the company may apply for reorganization, reconciliation, or liquidation. Reconciliation and reorganization provide companies with an opportunity to continue despite being presently unable to meet its debts as and when they fall due.

What is Reconciliation?

Reconciliation is a procedure open to the company to allow it to submit a plan to the creditors in respect of the payment of its debts. The reconciliation plan must be approved by a simple majority of the creditors who hold at least two-thirds of the unsecured debt. This will usually involve the creditors compromising on their claims against the company.

An application for reconciliation can be made prior to an application for bankruptcy, or after an application for bankruptcy but before bankruptcy is official declared.

If the company is unable to comply with the reconciliation agreement, creditors can then apply for restoration of the bankruptcy proceedings and execution of a declaration of bankruptcy.

What is the process of Reorganization?

After acceptance of a bankruptcy petition a company, or a shareholder holding more than 10 per cent of the equity in the company, may apply to the court for reorganization (Article 70). During reorganization either the company itself will continue its business and affairs, supervised by a court appointed administrator, or an administrator may be appointed to actually run the business (Articles 73 & 74). A reorganization plan needs to be submitted within 6 months of the company entering into reorganization (Article 79).

Pursuant to Article 81 the draft of revival plan shall include the following contents:

1. A business plan of a debtor;
2. Classification of the creditor's right;
3. An adjustment plan of the creditor's right;
4. A repayment plan of the creditor's right;
5. Term for implementing the plan;
6. Term for supervising the performance of the plan; and
7. Any other plan conducive to the company's reorganization.

Within 1 month of the draft plan being submitted, a meeting of creditors must be held to vote on the plan. The creditors will be grouped into the following categories at the meeting pursuant to Article 82:

1. Secured creditors;
2. Employees with entitlements or wages owing;
3. Taxation authorities in respect of tax owing; and
4. Ordinary unsecured creditors.

Approval of the reorganization must be given by more than half of the creditors in each category who hold more than 2/3 of debt within that category (Article 84). Within 10 days of the approval of a reorganization plan by the creditors, it shall be submitted to the court for final approval. On the condition that it is consistent with the Law, the court will grant such approval and implementation of the plan will commence.

What happens if consent is not given by one category of creditors?

An application may be made to the court for approval of the draft plan subject to the plan meeting various requirements as outlined in Article 87 of the Bankruptcy Law. These requirements are basically as follows:

1. The debt owed to secured creditors will be paid via identifiable assets and that any loss suffered from postponement of repayment will be compensated in a fair manner;
2. That, according to the draft plan, wages and employees entitlement and taxes owing, will be paid in full; or those groups consent to the plan;
3. That unsecured creditors will be repaid above a stipulated proportion of the debt; or the group has consented.
4. Where the plan provides a fair and justifiable adjustment to the rights and interests of capital contributors, or the contributors have adopted the draft of revival plan;
5. Where the plan treats the members of a same voting group fairly and the liquidation order of the creditor's right does not violate the provisions of Article 113 of the Bankruptcy Law; and
6. Where the business plan is feasible.

For the purposes of point 5 above, Article 113 is a provision that orders the priority of payments to unsecured creditors.

Lehman, Lee and Xu's *Briefing Paper Series* aims to provide readers with summaries of various China-related legal issues, designed to answer the questions most commonly asked by our clients.

For more information on the topics discussed in this briefing paper, please contact our Bankruptcy and Reorganization team.

Lehman, Lee and Xu's Bankruptcy and Reorganization specialists have experience and expertise in advising Chinese and international clients on all aspects of corporate restructuring in China, helping them to ensure the viability and continuation of their business in difficult economic circumstances.

For further information or enquiries, please contact mail@lehmanlaw.com