

ALERT



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China's New Enterprise Bankruptcy Law

This Restructuring Alert focuses on the recently promulgated Enterprise Bankruptcy Law of China. The Alert highlights the key features of the new law and compares important provisions of the Enterprise Bankruptcy Law with those of the United States Bankruptcy Code and administration under United Kingdom law. It is accompanied by a schedule summarizing the most relevant provisions of each jurisdiction. The enactment of this law represents a watershed moment for Chinese capital markets. We invite you to contact us with any questions about this Alert or for copies of any materials discussed in this Alert.

China's Enterprise Bankruptcy Law of 2006

On August 27, 2006, President Jintao Hu of China signed into law China's new Enterprise Bankruptcy Law, effective on June 1, 2007. The new law is groundbreaking and one of the most significant pieces of legislation for China's market economy. The new law clarifies many provisions of the 1986 Interim Enterprise Bankruptcy Law and will provide creditors and investors with more certainty, transparency and protection during a restructuring. The new law embraces many concepts drawn from the United States Bankruptcy Code, including the automatic stay, fraudulent conveyance/preference actions, approval of a plan of reorganization, and the appointment of a bankruptcy administrator, although the exact meaning and scope of these legal concepts remain untested. The most significant change for international investors is that the Chinese government will no longer play a leading role in a bankruptcy case.

Important additions to the new Enterprise Bankruptcy Law are as follows:

Who May Be A Debtor. Any legal person in China may be a debtor under the new law, regardless of whether the entity is state-owned (i.e., state-owned enterprise or "SOE"), private, or foreign-invested. For the first time in China's history, the bankruptcy of all legal persons in China will be governed by one uniform bankruptcy law. Previously, the 1986 Interim Enterprise Bankruptcy Law applied only to SOEs, and the bankruptcy of private enterprises and foreign-invested enterprises were governed by a different body of often contradictory or inconsistent laws. The new law continues to exclude partnerships, sole proprietors, and individuals. More importantly, the inclusion of financial institutions, e.g., commercial banks, insurance companies, and securities companies, in the new law could bring transparency and other long-term benefits to creditors who invest in this sector. However, the details of a bankruptcy of a financial institution remain to be developed. Due to the complex affairs of a financial institutions, Chinese regulatory or supervisory agencies may interfere with the administration of bankruptcy proceedings of financial institutions.

Notably, the Chinese government has exempted approximately 2,100 SOEs from the new law. These SOEs will be closed by the government by the end of 2008 pursuant to policy-arranged bankruptcy procedures; thus, when these SOEs are closed, employees' claims likely will be paid prior to secured claims. Closing over 2000 SOEs in the next two years could be a daunting job for the Chinese government, and thus it is likely that the government may seek assistance from foreign investors interested in purchasing the debts or assets of certain SOEs.

An enterprise may file a voluntary petition for bankruptcy only if two insolvency tests are met: 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"). On the other hand, an involuntary petition under the new law may be filed by a creditor when only the cash flow test is triggered. Similarly, in the U.S. and the UK, an involuntary bankruptcy or administration proceeding may be triggered solely by the debtor's inability to pay its debts when due without regard to balance sheet insolvency. The requirement of both cash flow insolvency and the balance sheet insolvency for a voluntary proceeding under the new law could be problematic given the lack of transparency and uniformity of accounting standards and the practice of maintaining two sets of books and records for non-public companies in China. As further discussed below, this is one of the many aspects of the new law that needs further legislation or interpretation from the Peoples' Supreme Court of China.

The Automatic Stay. The new law imposes an automatic stay in limited circumstances. For example, the new law provides that during the pendency of the bankruptcy case any civil lawsuit involving the debtor can only be commenced in the same people's court that accepts the bankruptcy petition. However, the stay is not as comprehensive as its counterpart under the U.S. Bankruptcy Code. For instance, the new law provides that any civil lawsuits or arbitration proceedings initiated prior to the commencement of the bankruptcy case are suspended after the court accepts the bankruptcy petition but may resume after a bankruptcy administrator is appointed by the court. Also, creditors may take advantage of a 15-day window period between the date the bankruptcy petition is filed and the date the court grants the petition to enforce their security interests or otherwise collect their debts. The People's Supreme Court should issue an opinion imposing an interim stay during the window period.

The new law also specifies that after a court accepts the bankruptcy petition, the debtor cannot pay any pre-

bankruptcy debts, and any such payments are void *ab initio*. Again, it is unclear whether the payments made during the 15-day window period should also be void *ab initio*. Similar to the U.S. Bankruptcy Code and UK administration, the new law provides that interest on unmatured debts stop accruing as of the date the court grants the bankruptcy petition. Unlike the U.S. Bankruptcy Code, however, under the new law an oversecured creditor cannot recover postpetition interest during the pendency of the bankruptcy case.

Finally, under the new law a creditor is prohibited from enforcing its rights against the property of the debtor after the bankruptcy petition is accepted by the court. Similar to the concept of adequate protection in the U.S., however, the new law provides that in a reorganization a court may allow a creditor to foreclose against collateral if that collateral is diminishing in value or is being damaged.

Executory Contracts. There is only one provision in the new law that addresses executory contracts. It provides that the bankruptcy administrator is authorized to terminate or continue to perform pre-bankruptcy contracts if there are obligations to be performed by each contracting party. The new law requires the administrator to decide whether to terminate or perform within two months of the court's acceptance of the petition or 30 days after the non-debtor contracting party requests a decision; otherwise the contract is deemed terminated. The contract may also be deemed terminated if the administrator fails to guaranty the continued performance of the contract upon a request by the non-debtor contracting party.

Priority. One of the most debated issues in the new law is the priority of displaced workers' compensation claims. Prior to the enactment of the new law, workers' compensation claims were often paid ahead of secured claims. The new law reverses the current practice and provides that in a liquidation, secured claims receive distributions to the extent of the value of the collateral, and any deficiency claim is treated as a general unsecured claim. The unsecured creditors should receive their distribution in the following order:

First, post-bankruptcy administrative costs and expenses are entitled to first priority in distribution;

Second, post-bankruptcy liabilities for "common benefits"¹ are entitled to second priority in distribution;

Third, workers' compensation claims² are entitled to third priority in distribution;

Fourth, social insurance expenses not included in third priority distribution and tax claims are entitled to fourth priority in payment; and

Fifth, general unsecured claims are the last to be paid from the debtor's estate.

Reorganization. Significantly, the new law devotes an entire chapter to reorganization. Either a debtor or a creditor may apply to the court for a reorganization. A debtor in possession may manage its assets and operate its business under the supervision of an administrator, or the administrator may operate the business and administer assets by engaging existing management. In cases where there is both a debtor in possession and an administrator, it is not clear what the relative power and control will be between the two.

Notably, the new law gives the debtor in possession or the administrator the exclusive right to propose a plan of reorganization for six months after the reorganization application is accepted by the court; this exclusivity period may be extended for another 3 months. Unlike the U.S. Bankruptcy Code, which gives creditors and other parties in interest the right to propose competing reorganization plans upon the expiration of the exclusivity period, the new law simply provides that if exclusivity expires, the court shall terminate the reorganization case and declare the enterprise bankrupt.

The new law allows all creditors to vote on a reorganization plan and divides the creditors into four classes for plan voting purposes: secured creditors, workers' compensation claimants, tax claimants, and other general unsecured creditors. In addition, the court may allow the holders of *de minimis* claims to vote on the plan as a separate class.

Under the new law, a creditors' meeting must be held to vote on the reorganization plan. Similar to the U.S. Bankruptcy Code and applicable exit mechanisms under UK administration such as schemes of arrangement, under the new law, the plan must be approved by an affirmative vote of two-thirds of the total amount of the claims in each class and a majority of the creditors in such class that are present at the creditors' meeting. The plan can be approved only if all four voting classes vote in favor of the plan, although the court may "cram down" a dissenting class if certain conditions are satisfied, similar to the cramdown process in the U.S. and UK. It remains to be seen whether cram-down under the new law is a feasible alternative.

In addition, the new law allows debtor in possession financing by the debtor in possession or the administrator. But the new law is silent as to whether the debtor in possession lender can be entitled to superpriority status or a priming lien, as provided under the U.S. Bankruptcy Code.

Fraudulent Conveyance and Preference. The new law also introduces the concept of avoidance actions, *i.e.*, fraudulent conveyances and preferences. For instance, the new law authorizes the court to avoid, upon request of the administrator, certain fraudulent conveyances of the debtor's property within one year prior to the date the court accepts the bankruptcy petition, and any payment made for the benefit of a creditor within the six month period prior to the date the court accepts the bankruptcy petition if the debtor was insolvent at the time.

Administration or Management of the Bankruptcy Estate.

The new law authorizes the court to designate a bankruptcy administrator to manage the affairs of the debtor and therefore reverses the current practice of designating a government-appointed liquidation group. The creditors may later ask the court to remove the administrator if the administrator fails to perform its duties. The administrator reports to the court but is supervised by a creditors' committee. The new law authorizes the People's Supreme Court to issue an opinion on the details of the designation and compensation of the administrator, but does provide that the administrator's compensation is subject to review and objection by creditors. It will be interesting to see what roles the creditors and the court will play in approving the administrator's compensation.

Government liquidation groups (most likely asset management companies), accounting firms, law firms, and any certified administrator may serve as an administrator. It is not clear whether foreign law firms or accounting firms will be allowed to serve as bankruptcy administrators, although their inclusion of experienced and efficient foreign experts will likely facilitate the implementation of the new law.

The Creditors' Committee. As described above, the creditors' committee has extensive involvement in the bankruptcy case. For instance, the administrator must report to the creditors' committee for any significant asset disposition activities affecting the interests of the creditors. The creditors' committee also supervises the management, disposition and distribution of the bankruptcy estate. In particular, creditors may ask the court to remove the administrator and review

the administrator's compensation, supervise the administrator, determine whether the debtor should remain as a going concern, or adopt the reorganization plan, settlement agreement, or other asset disposition plan.

Cross-border Insolvency. Finally, for the first time, the new law purports to extend to assets of a debtor located outside the territory of China. In addition, the new law allows the court to recognize and enforce foreign court orders and judgments to the extent such orders or judgments may be enforced or recognized by a Chinese court pursuant to existing treaties, international conventions, or the principle of comity. As there is no such treaty for enforcing judgments between China and the U.S. or the UK, it will be very

interesting to see whether a Chinese court will be willing to enforce a U.S. or UK court order against assets located in China or vice versa.

Overall, the new law is very sophisticated and market-based. It embraces many internationally recognized insolvency concepts, streamlines bankruptcy procedures, and better protects the interests of creditors, which will greatly improve the investment environment in China. The new law now provides an exit strategy for foreign investors and should generate more confidence in the Chinese market. Although the new law is far from perfect and requires further clarification in certain respects, there is no doubt that it has a very bright future.

1 Liabilities for "common benefits" are: (i) liabilities arising from post-bankruptcy performance of the executory contract; (ii) liabilities arising from *negotiorum gestio* of the debtor's assets by another; (iii) liabilities arising from the debtor's unjust enrichment; (iv) post-bankruptcy labor costs, social security insurances and other related expenses incurred during post-bankruptcy operations; (v) personal injury liabilities caused by the administrator or its professionals in fulfilling their duties; and (vi) personal injury liabilities caused by the debtor's products.

2 Workers' compensation claims are broader than the concept in the U.S. and include wages and salaries, medical expenses, pensions for the disabled and their survivors, medical insurance premiums, and other compensation. Unlike the U.S. Bankruptcy Code, the new law does not cap workers' compensation claims. In addition, as a compromise to protect workers' interests, the new law provides that workers' compensation claims incurred prior to August 27, 2006, the date the new law was promulgated, will be paid before secured claims.

Schedule Comparing Key Aspects of U.S. Chapter 11, UK Administration and Chinese Bankruptcy Law

ITEM	CHAPTER 11	UK ADMINISTRATION	CHINESE BANKRUPTCY
Applicable Law	U.S. Bankruptcy Code	Insolvency Act 1986	China's Enterprise Bankruptcy Law of 2006
Applicable supervisory court	U.S. Bankruptcy Court	High Court of England & Wales	The People's Court in the debtor's domicile
Purpose	Reorganization – requirement of insolvency (cash flow test <u>only</u> for involuntary petitions instituted by creditors).	Rescue, or achieving a better result for creditors than if the Company were immediately wound up, or realising property to make a distribution to secured or preferential creditors (in that order)- requirement for insolvency (cash flow <u>or</u> balance sheet).	Reorganization, conciliation or liquidation, with a requirement for insolvency (cash flow <u>and</u> balance sheet for voluntary proceedings and cash flow only for involuntary proceedings).
Commencement	Court petition by debtor or three creditors holding non-contingent, undisputed claims aggregating at least \$12,300 more than the value of any collateral.	Court petition by debtor, debtor's directors or creditors, or out-of court appointment by debtor or its directors, or the holder of a qualifying floating charge.	Court application by debtor or creditor.
Moratorium	Yes, extensive - upon filing of petition. Applies unless leave of court is given. In some cases, can be extended to actions against third parties if necessary to protect debtor.	Yes, extensive - from date application to court is made or when notice of intention of appointment of administrator is filed with the court or where no notice is necessary from the time the relevant forms are filed with the court. Applies unless leave of court is given.	Yes, limited - once the application for bankruptcy is accepted by the court, any litigation or arbitration involving the debtor is suspended but can be resumed once the administrator is designated. Also, a 15-day window period between time of filing petition and grant of bankruptcy during which creditor may foreclose against its collateral.
Control of procedure	Debtor remains in possession unless a trustee is appointed by the court for cause, including fraud, dishonesty, incompetence or gross misconduct. Examiner may also be appointed to investigate debtor's affairs.	Registered insolvency practitioner (administrator) who is usually an accountant is an "officer of the court" and has duties to the court and the creditors. Management of debtor transfers to the administrator. Director's powers are suspended. Administrator may delegate powers back to directors and management as appropriate. The administrator is appointed by the petitioning party.	Debtor in possession and/or court-designated administrator may manage the affairs of the debtor. The creditors' committee can be actively involved in the management of the debtor's affairs.

ITEM	CHAPTER 11	UK ADMINISTRATION	CHINESE BANKRUPTCY
Secured Creditors	Entitled to adequate protection (e.g., cash payment for loss in value, replacement lien).	Have first priority protection and the right to enforce their security and appoint an administrator before other creditors.	General provision permitting adequate protection. What constitutes "adequate protection" is unknown.
Claim priorities	Secured, bankruptcy expenses, priority claims (e.g., taxes), unsecured claims.	Secured, expenses, preference claims, unsecured claims.	Secured, bankruptcy expenses, priority claims, unsecured claims.
Creditors' Committee	Yes. As soon as practicable after commencement of Chapter 11, the U.S. Trustee appoints a creditors' committee usually made up of the seven largest unsecured creditors willing to serve.	Optional, to be decided by the creditors' meeting at the first meeting of creditors (maximum 10 weeks after appointment) the administrator may appoint a creditors committee - membership optional.	May be established at the creditors meeting. Will include creditor and employee representatives. A maximum of nine persons.
Proposal to creditors	Only the debtor may propose a reorganization plan for the first 120 days after petition, which exclusivity may be extended up to 18 months after the petition date. After this period the creditors' committee or an individual creditor may propose a plan. Debtor also has 180 days to obtain acceptances of the plan from impaired creditors and shareholders which period may be extended to 20 months after the petition date. A court approved disclosure statement must precede the solicitation of votes on the plan. Applies to all claims and equity interests.	Within 8 weeks of commencement of administrator's appointment (or longer period as court may specify), the administrator must send his proposals for achieving the purposes of the administration to the creditors and within 10 weeks of commencement of appointment present these proposals to the creditors' meeting. Meeting may accept, reject or accept with modifications the proposals.	Only debtor or bankruptcy administrator may propose a reorganisation plan with a six-month exclusivity period, which may be extended for three months. Four classes of creditors are entitled to vote on the plan: secured creditors, workers' compensation claimants, tax claimants and other general unsecured creditors.
Method of exit from process	The objective in a reorganization case is the confirmation of the plan. A plan is the master document that provide for the recoveries by all interest holders and creditors, and the transactions through which the debtor will carry out its plan. A plan confirmed by the court is binding on the debtor, all interest holders and creditors (even dissenting ones), except in rare cases, certain debts cannot be discharged by a debtor.	The administrator may propose a company voluntary arrangement (CVA) which will act as a contractual variation of a creditors' claims against the company, or a scheme of arrangement which is a court sanctioned arrangement between a company and its creditors (or any class of them) or its debtors. A distribution may also be made within the administration.	A plan provides for the recoveries by all interest holders and creditors, and the transactions through which the debtor will carry out its plan. A plan confirmed by the court is binding on the debtor, the creditors and the interest holders. The administrator is authorized to supervise the implementation of the plan, and reports to the court.

ITEM	CHAPTER 11	UK ADMINISTRATION	CHINESE BANKRUPTCY
Voting requirements for approval of plan	A majority in number and two-thirds in value for each affected class. Cramdown of rejecting classes allowed subject to certain standards.	For a CVA, 75% in value of those creditors present and voting at meeting. For a scheme, a majority in number and two-thirds in value for each affected class. Cram-downs apply.	A majority in number and two-thirds in value for each affected class present at the creditors' meeting for plan voting. All classes must approve for a plan to be effective, but cramdown applies subject to specified factors similar to those under Chapter 11.
Expenses	Paid from bankruptcy estate, subject to strict court supervision. Expenses have priority.	Costs of the administration are paid after fixed charges but before all other claims. Priority of payments within this category is set down in law. The remuneration of the actual administrator is toward the bottom end of this list.	Paid from bankruptcy estate. Administrator's expenses subject to creditors' committee review and court approval. Bankruptcy expenses are paid in first and second priority.
Recognition of Foreign Proceeding	Centralizes the process of recognition of foreign proceedings (both main and non-main proceedings) in the bankruptcy courts. Upon recognition of the foreign proceeding, several provisions of the Bankruptcy Code automatically apply with respect to the debtor and all of its property within the territorial jurisdiction of the United States, including the "adequate protection" of a secured creditor's interest in property of the debtor, the automatic stay, and the right of the foreign representative to use or sell the debtor's property and adequate protection of the interests of secured creditors. Additional assistance may also be granted subject to standards.	Regimes apply to recognize foreign proceedings depending on the location and type of proceeding. The EC Regulation on Insolvency Proceedings applies to European proceedings, section 426 of the Insolvency Act applies to Commonwealth proceedings, and the Cross-Border Insolvency Regulations 2006 (implementing the UNCITRAL Model Law, as Chapter 15 of the Bankruptcy Code does in the U.S.), recognizes proceedings and grants relief depending on whether the proceedings are foreign "main" or "nonmain". Court discretion generally applies.	Under limited circumstances permitting recognition of foreign orders and judgments based upon principle of comity or international convention. Details on implementation of such provision need to be developed.

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