



Local Concerns Outweigh Offshore Creditors' Interests in Chinese Restructurings

BY JOHN M. MARSDEN, PARTNER & SALLY MUI, SENIOR ASSOCIATE, MAYER BROWN JSM

Bankruptcies and reorganizations are viewed in the People's Republic of China (PRC) as very much a practical issue.¹ Avoiding social unrest is a key concern for the government. Reorganizations, if they are to take place, often involve the government, and uncooperative foreign creditors rocking the boat are not welcome.

Historically, successful reorganization cases involve "ST (special treatment) companies," which are companies that have reported losses for two consecutive years or which have negative shareholder value and are at risk of losing their listing status on the Shenzhen and Shanghai stock exchanges.² While these reorganizations may be viewed as demonstrating the effectiveness of

the PRC rehabilitation model, they have been disappointing from the perspective of offshore creditors. The restructurings often lack transparency, provide limited financial information to interested constituencies, and result in low creditor recovery rates.

Furthermore, management of a failing PRC company often has strong business and political ties in the region. The government, be it local or provincial—whose support is often critical for a successful outcome to any reorganization—will only endorse an outcome that benefits the local business community.

The structuring and attraction of overseas capital to the PRC plays a major role in challenges that arise for offshore creditors. This article first

addresses those challenges and then looks at additional practical issues that surround reorganization in the PRC.

Investment Structure

A typical lending structure used by a PRC company involves offshore financial creditors advancing loans, making available banking facilities, and/or subscribing for notes or bonds issued by a separate company (either a parent or an intermediate holding company) incorporated outside the PRC and possibly listed on one of the established stock exchanges. That company holds shares of the domestic PRC company, which in turn holds the assets and operations of the business. Loans are often made on an unsecured basis or with

continued on page 24



In the absence of formal recognition of their appointments, both appointment holders and creditors face many difficulties in engineering any local reorganization or enforcing the rights of creditors.

continued from page 23

guarantees given by group companies. Sometimes, share pledges or debentures may also be executed as security.

The purpose of funding obtained offshore is usually to finance operations in China. This is accomplished by the parent or intermediate holding company injecting funds into the operating subsidiaries by way of equity and shareholder loans.

This structure presents two principal problems when defaults occur and offshore financial creditors seek repayment of their indebtedness. First, the offshore financial creditors' debts are likely to be structurally subordinated to those of the operating subsidiaries unless the offshore financial creditors have direct claims against the operating subsidiaries (through guarantees or other security). Any value obtained from the operating subsidiaries will be used to repay the operating subsidiaries' debts first before any surplus can flow up the shareholding chain and back to the parent/intermediate holding company.

Secondly, any paid up capital injected into the operating subsidiaries is often unrecoverable by the parent/intermediate holding company in a distressed situation unless upon bankruptcy of the operating subsidiaries there is any surplus value available for distribution to shareholders.

When an amicable settlement or restructuring plan cannot be agreed upon, offshore financial creditors may seek to recover their investments by

exercising any legal remedies available to them. If security such as a debenture or share pledge has been created, receivers and managers may be appointed over the debenture charge or the pledged assets. If no security was given to secure the lending, offshore financial creditors may seek to appoint provisional liquidators or liquidators over the parent or intermediate holding company in its jurisdiction of incorporation.

Due to the historical restrictions that have been imposed by the State Administration of Foreign Exchange of the PRC on Chinese companies in providing security for offshore loans, offshore financial creditors in the past were unlikely to have obtained any form of tangible security given by the operating subsidiaries in China. At most, the operating subsidiaries might have guaranteed the principal indebtedness, and sometimes the offshore shareholder might have pledged its equity interests in the operating subsidiaries as security for the loan. Those restrictions have recently been relaxed by the "Regulations on Foreign Exchange Administration of Cross-Border Guarantees and Security" and the "Operational Guidelines on Foreign Exchange Administration of Cross-Border Guarantees and Security."

As a matter of PRC law, any guarantee given in favor of offshore financial creditors before June 1, 2014, requires approval from the State Administration of Foreign Exchange (SAFE). Without that approval, offshore financial creditors cannot formally remit any repayments out of China that are received from the

guarantors. One of the ways in which an offshore financial creditor may enforce a guarantee that is not approved by SAFE is by issuing court proceedings in China, but the maximum amount that may be recovered is 50 percent of the guaranteed amount.³

Share pledges given by the shareholder of the operating subsidiaries do not require approval from SAFE. Nevertheless, to be effective, the share pledges must be approved by the local Ministry of Commerce and then registered with the local State Administration of Industry and Commerce if the underlying equity interests relate to a foreign invested enterprise. The approval and registration process can be time-consuming, and enforcement of the share pledges is not straightforward.

China's Property Law provides that "where an obligor fails to pay his due debts or any circumstance for realizing the pledge right as stipulated by the parties concerned occurs, the pledgee may cash the pledge or seek preferential payments from the proceeds of the sale or auction of the pledged properties." If the pledgor and the pledgee fail to agree on the enforcement mechanics, the pledgor will have to enforce the share pledges through the courts.

Recognition

For these and other reasons, foreign creditors often find it difficult to get their feet under the table at any proposed domestic restructuring, because their loans are structurally subordinated unless they were made directly to PRC

operating entities. Foreign creditors have tried to get to the table through offshore appointments (liquidation, provisional liquidators, or receivership). If recognized by PRC courts as the controller of the parent/intermediate holding company, offshore appointment holders would expect to exercise shareholders' rights to exert control and influence over the operating subsidiaries and effect a reorganization or realization strategy.

The UNCITRAL Model Law on Cross-Border Insolvency provides a framework of legislation for how the courts of one country should recognize insolvency proceedings commenced in another country. However, China has not adopted the Model Law.

Instead, the PRC Enterprise Bankruptcy Law provides a general principle for recognition of foreign court judgments on insolvency matters that relate to any assets located in China. There are similar provisions contained in the PRC Civil Procedure Law.

The law provides that Chinese courts will only recognize foreign court judgments made in insolvency proceedings that involve assets located in China when (a) an international treaty for mutual recognition of such proceedings is in effect with that foreign jurisdiction; or (b) on the basis of the principle of reciprocity, provided that the judgments do not violate basic principles of the laws of the PRC; do not jeopardize the sovereignty, national security, or public interests of the PRC; and do not undermine the legitimate rights and interests of creditors in China.

As a result, Chinese courts are prepared to recognize foreign bankruptcy judgments in certain instances. For example, B&T Ceramic Group s.r.l.,⁴ a company domiciled in Italy, applied in the PRC for recognition of the Milan Court's bankruptcy order with respect to E.N. Group s.p.a. The Guangdong Foshan Intermediate People's Court determined that the judgments by the Milan Court were subject to a treaty between China and Italy, and thus issued an order to recognize them.⁵ However, China to date has only entered into international treaties for mutual recognition of proceedings with Italy and Turkey, so this approach may not work in countries with which the PRC does not have treaty arrangements.

As for relying on the principle of reciprocity as grounds for Chinese courts

to recognize foreign court judgments, there is no judicial guidance on what kinds of judgments violate basic principles of PRC laws; jeopardize the nation's sovereignty, national security, or public interests; or undermine legitimate rights and interests of creditors in China. As such, the legal provisions offer limited practical guidance, and there is great uncertainty whether the role of the offshore appointment holders vis-à-vis the parent/intermediate holding company will be recognized before Chinese courts.

Challenges for Appointment Holders

In the absence of formal recognition of their appointments, both appointment holders and creditors face many difficulties in engineering any local reorganization or enforcing the rights of creditors. The offshore appointment holders face further difficulties when seeking to exercise an estate's rights as shareholder of the operating subsidiaries. Some of the practical challenges faced by offshore appointment holders are:

Inability to Change Management.

Offshore appointment holders usually find it challenging to remove a company's existing directors and legal representative⁶ in a timely manner without those individuals' cooperation because the local State Administration of Industry and Commerce requires that documents be executed by those affected to effect the change. Furthermore, the key man of the borrower group often has established relationships with local authorities and may exert political influence to prevent registration of any management change. Even if resignation documents were presigned as a condition of the loan, the local State Administration of Industry and Commerce may not accept submission of documents from offshore appointment holders' representatives, though a recent court decision may alter that practice.

On June 11, 2014, the Supreme People's Court overturned a decision of the Fujian High Court in the case of Sino-Environment Technology Group Limited, ruling that a sole shareholder resolution passed to remove the legal representative of a PRC company is valid and enforceable, even though the records of the local State Administration of Industry and Commerce had not been updated. Thus, the legal representative no longer has authority to act on behalf of the PRC company once the sole shareholder resolution has been passed.

In the Sino-Environment case, the legal representative commenced legal proceedings in the name of the PRC company against its sole shareholder, which was in liquidation, seeking payment of the outstanding capital contribution. The Supreme People's Court agreed that the legal representative did not have authority to act on behalf of the PRC company to commence the proceedings, given that a shareholder resolution had been passed to remove him prior to the commencement of the proceedings.

Inability to Obtain Physical Possession.

Without the ability to remove the directors and legal representative and appoint their own nominees, offshore appointment holders cannot obtain physical possession of the premises, title certificates, chops (a stamp-like device used to imprint a Chinese company's official mark to validate contracts and other documents), business licenses, and books and records of operating subsidiaries. Fearing unwelcome change and a loss of jobs, local management and workers of operating subsidiaries are hesitant to hand over control. Workers are concerned that outstanding wages will not be paid if valuable assets, such as machinery and inventories, are removed from the premises. The personal safety of offshore appointment holders and their agents may be threatened during the course of obtaining possession.

Interference by Local Governments.

In some instances, municipal governments may step in and take control over a company's assets in China to preserve stability and protect the interests of local workers and suppliers. In the case of Smart Union Group (Holdings) Limited,⁷ a toy producer listed in Hong Kong, the local government applied to the local courts to seize and auction the company's assets located in Dongguan to pay outstanding wages and thereby prevent social unrest. The wages were settled in advance by the local government, the assets were auctioned, and the proceeds of the sale were used to repay the local government.

Asia Aluminium Holdings Limited,⁸ which owed US\$17.7 billion of debt to both onshore and offshore creditors, applied for its own provisional liquidation offshore. Notwithstanding the interest expressed by a Norwegian aluminium investor to acquire the underlying assets, the business was ultimately sold

continued on page 26

by the provisional liquidators to parties close to the company's management, given that the local government fully supported such an arrangement.

Political, Commercial Pressures

However, in some cases offshore creditors have successfully recovered portions of their claims. In the case of Skyfame Realty (Holdings) Limited,⁹ for example, receivers were appointed over 51 percent of the shares in an offshore holding company. The receivers linked up with a Guangzhou-based, state-owned enterprise to exert commercial pressure on the borrower company and, as a result, the borrower company entered into an amicable repayment plan with the creditors.

In the case of China Sun Bio-Chem Technology Group Company Limited,¹⁰ provisional liquidators were appointed over the Cayman Islands offshore entity that held shares in the target. The provisional liquidators, in their capacity as directors of the immediate shareholder, then went to court in the Wuzhong District of Suzhou, Jiangsu, where the underlying subsidiaries were registered, seeking an order to compel the legal representative to surrender the company chops and business licences of the subsidiaries to facilitate the registration of the change of the legal representative at the local authorities.

The court refused to effect the change. Subsequently the provisional liquidators appealed to the Suzhou Intermediate People's Court, where the controlling onshore shareholder was thought to have much less influence. Before a ruling was made by the appellate court, the company agreed to settle at improved terms.

FerroChina Limited¹¹ was another case in which local government support played an important role in achieving a favorable outcome for offshore lenders. The company fell into financial difficulties shortly after the collapse of Lehman Brothers, and receivers were appointed over FerroChina's parent holding companies in the British Virgin Islands.

A crucial factor in the case was that the controlling shareholder, who was from Taiwan, had absconded and did not seek to exert influence over or obstruct the restructuring. Some onshore security had been given in favor of the offshore lenders, and the

company allowed those lenders to have control over the company chops.

The onshore operating subsidiaries applied for restructuring under the PRC Enterprise Bankruptcy Law. The receivers had built a good relationship with the local government officials from an early stage of the restructuring and provided the necessary expertise and assistance to the officials. The Chinese court approved the restructuring plan for all the creditors of the onshore operating subsidiaries, which included offshore creditors that held direct claims against the onshore operating subsidiaries. The involvement of the local government was likely essential to the good recovery achieved by the offshore creditors.

Not only do creditors and offshore appointment holders face hurdles when trying to be heard in onshore restructurings, but PRC borrower groups and onshore creditors also are increasingly adopting strategies to shield PRC operational subsidiaries' assets from offshore creditors. A recent illustration of the strategies adopted by the different stakeholders involved Suntech Power Holdings,¹² a U.S.-listed solar panel maker with its headquarters in Wuxi, China. In March 2013, Suntech defaulted on its redemption payment obligations to a group holding convertible bonds with a face value of US\$541 million.

Three days later, eight Chinese banks filed a bankruptcy petition against Suntech's Chinese subsidiary Wuxi Suntech Power Co. Ltd. in the Wuxi Municipal Intermediate People's Court in Jiangsu Province. Suntech did not object to the petition. Any restructuring implemented through the PRC Enterprise Bankruptcy Law would involve creditors of Wuxi Suntech but not bondholders, who do not have direct claims against Wuxi Suntech. Subsequently, Suntech and the bondholders agreed to a standstill until May 15, 2013.

In response, four bondholders petitioned for Suntech's involuntary bankruptcy under Chapter 7 of the U.S. Bankruptcy Code. Suntech claimed it would challenge the petition. A month later, Suntech applied for provisional liquidation in the Cayman Islands to implement a restructuring. In January 2014, Suntech entered into agreement with its bondholders to replace the Chapter 7 case with a Chapter 15 filing for recognition of the Cayman Islands proceedings

to enable Suntech to implement a restructuring by way of a sale of assets.

Suntech illustrates how creditors holding no direct claims against an operating subsidiary in China may need to use offshore remedies to obtain a better outcome in the domestic restructuring.

Outlook

The PRC Enterprise Bankruptcy Law provides a framework for reorganizing or restructuring Chinese companies. However, the process is generally politically driven and not sufficiently transparent, especially when the company involved is a state-owned enterprise and/or has extensive local government influence. As a result, onshore reorganization of PRC companies has not been a success story to date for foreign creditors. Better outcomes can be expected in cases in which management may want to preserve an offshore listing.

Foreign investors in PRC operations must continue to grapple with the issues of structural subordination and local government intervention. There is evidence that foreign creditors may enjoy greater local authority support than in the past. Even so, investors should still consider the location of operations and assets within a target group's corporate structure, the long-term cash flow of onshore and offshore companies involved, and, if practicable, the level of support from the Chinese government.

Investors must remain alert to any assistance provided to foreign creditors by local authorities and courts, as these may provide greater opportunities for preemptive action by onshore creditors. ■

¹ John M. Marsden and Phoebe Lo, "Experiencing the Great Wall – Reorganizations under the PRC Enterprise Bankruptcy Law," *INSOL World*, Fourth Quarter 2012.

² Presentation as "An Update on the PRC Bankruptcy Law," given on October 12, 2011, by C.W. Tang, Shine Wing (HK) CPA Limited.

³ This is in accordance with Article 7 of the Judicial Interpretation of the Supreme People's Court on Certain Issues Regarding the Application of the Security Law of the People's Republic of China. On June 1, 2014, Chinese regulators started to relax these rules and allow companies to simply inform regulators of the guarantees rather than seeking approval for them.

⁴ See B&T Ceramic Group referred to in Jingxia Shi, "Recent Developments in Chinese Cross-Border Insolvencies," available at iiiglobal.org.

⁵ *Ibid.*

⁶ Under PRC Company Law, a company's appointed legal representative has absolute

power to enter binding agreements on behalf of the company. However, legal representatives also bear the risk of being subjected to personal liability for their actions.

⁷ The author advised the provisional liquidators in the matter and therefore was aware of the dealings with the local government.

⁸ "International creditors do stand a chance in China. Here is how," Debtwire, 22 July 2011.

⁹ *Ibid.*

¹⁰ *Ibid.*

¹¹ *Ibid.*

¹² The chronology of information is based on the disclosures made by Suntech on its website, suntech-power.com/en/about/about-suntech



John Marsden is a partner of Mayer Brown JSM in Hong Kong and represents clients in a wide range of matters in the commercial and corporate context. His assignments have included financing transactions, nonperforming loan disposals, and corporate restructurings, and he has advised on such large-scale restructurings or insolvencies as Asia Pulp and Paper, the Benpres Group, Forefront International Limited, the Moulin Group, TMT, and Vietnam Shipbuilding Industry Group, all of which are multijurisdictional transactions. Marsden is also the partner in charge of the firm's Vietnam offices.



Sally Mui is a senior associate of Mayer Brown JSM in Hong Kong and specializes in cross border corporate restructuring with a focus on advising multinational and Chinese enterprises, as well as bilateral and multi-bank groups. She has advised with respect to the restructuring of public and private companies, enforcement of security, and in particular appointment of receivers, creditors' schemes of arrangement, and loan and security assignments. She speaks English, Cantonese, and Mandarin.