

ENTERPRISE INSOLVENCY IN THE TIME OF COVID-19: GIVING CREDITORS A STRONG VOICE

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Since the outbreak and rapid spread of COVID-19 around the world, the Chinese economy has been suffering one of the most severe impacts. The data from the National Enterprise Bankruptcy Information Disclosure Platform reveals that the number of enterprise insolvency cases nationwide has reached 300,000 (as of December 7, 2022). Generally speaking, companies established by the U.S. corporates in China are usually engaged in manufacturing and service industries. Due to the complex and ever-changing nature of the current global economy, their essential customers in the mass production chain may go into insolvency proceedings due to worsening economic situations. This article will introduce important creditor rights for these foreign-invested companies in the Chinese insolvency proceedings, in addition to declaring claims.

As early as the drafting stage of the Chinese Enterprise Insolvency Law, there were many references to international legislative experience, including U.S. legislation. As such, some types of bankruptcy set out in the U.S. Bankruptcy Code could also be found in the Chinese legal frameworks,

such as liquidation and reorganization. For the creditor ranking determined in the PRC Enterprise Insolvency law and judicial interpretations, the priority of creditor rights is in descending order:

- Secured claims.
- Bankruptcy expenses.
- Common benefits debt (which are not separated from bankruptcy expenses under the U.S. insolvency framework).
- Employee claim.
- Taxes.
- General unsecured claims.

RECLAMATION RIGHT

Content of the right

Reclamation right under Chinese enterprise insolvency structure usually refers to the right to recover property that is not owned by the insolvent but in the possession and management of the insolvency representative. Specifically, the scope of such property defined in judicial interpretations is mainly based on the legal relationship such as storage, custody, processing, agency transaction, sale by proxy, borrowing, deposit, lease, title retention, etc. The owners

or other rights holders just need to apply to the insolvency representative for scrutiny instead of declaring. If the insolvency representative does not approve, they could bring an action against the insolvent.

In practice, reclamation right is usually exercised in the title retention sale contract. Whether the seller reclaims the goods, the insolvency representative has the power to decide to continue the performance or terminate. Firstly, if the contract continues to be performed, a seller could reclaim its goods if the insolvency representative fails to pay in due course or fulfill other contractual obligations, or the goods are improperly disposed of, except that the buyer (the insolvent) has already paid for more than 75% of the total price, or a bona fide third party has obtained the ownership or other property rights. The loss and damage caused by the aforementioned shall be categorized in the common benefits debt.

Secondly, if the contract is terminated, the seller should make a refund before reclaiming. However, if the value of the goods is evidently reduced, where the buyer's payment is not enough to makeup, the seller

could claim for such loss, which is treated as common benefits debt.

Hence, it is recommended to make agreements on the title retention clause with the customers in purchase and sale contracts if customers are not in a good financial situation. The title retention clause will enable the reclamation and thus make the seller take back the goods or the consideration from the insolvent.

Restrictions

Firstly, sellers shall pay for the costs incurred to reclaim the goods. The insolvency representative has the power to decline if the seller fails to pay.

Furthermore, sellers shall reclaim to the insolvency representative before the realization plan of the insolvent's property, settlement agreement or draft plan of reorganization is submitted to the creditors' meeting for voting. For those who reclaim after the deadline should bear the increased cost.

Finally, in the insolvency reorganization proceedings, the exercise of the reclamation right shall comply with the terms and conditions agreed in advance to protect the insolvent's property from being taken away at will. Otherwise, the insolvency representative has the power to decline.

AVOIDANCE ACTION

Avoidance action shall generally be taken by the insolvency representative if the insolvent (a) transfers the property without consideration; (b) makes transactions at obviously unreasonably price; (c) provides security on the unsecured property; (d) pays off undue debts; (e) waives claims 12 months before the court accepting the insolvency filing, or if the insolvent is unable and its property is insufficient to pay off its debt due, or it clearly lacks solvency but still makes prepetition payment to individual creditor six months before the court accepting the insolvency filing.

However, when the insolvency representative fails to do the aforementioned, the creditors may supervise and urge it to exercise - and also, may directly bring an avoidance action - to recover the insolvent's property.

In practice, there are three key points summarized from the judicial judgments. Firstly, in the viewpoint of the Supreme Court, the insolvent's provision of security for others without consideration is not fundamentally different from "transferring property without consideration." Secondly, for the determination of transactions at an obviously unreasonable price in judicial judgments, it generally refers to the transaction price of less than 70% or more than 30%

of the government guidance price or market price at the time of transaction. Thirdly, regarding the specific requirements of the provision of security interest, avoidance action could be exercised under the circumstance where the security is provided on the pre-existing debt. In other words, where the insolvent provides security together with the main contract entered into with the creditor is not included in the avoidable cases.

SECURED CLAIMS

Security interests are the common basis of the exemption rights in enterprise insolvency proceedings. The nominate security interests under the PRC Civil Code are mortgage, pledge, and lien. In principle, such secured property should be exempted from the insolvent's property to be divided among all general creditors. The exception is that during reorganization, the exercise of secured claims is suspended if the secured property is necessary for the reorganization. In practice, creditors with security interests in the insolvency proceeding are generally banks, trust companies, and other financial institutions or their assignees of the secured claims. The principal form of security interest granted over real property is a mortgage. For the mortgage to be established and enforceable against third parties, it must be registered under the local Real Estate Registration Center.

To guarantee the performance of the contracts with customers, other common practical approaches could also be employed by the creditors. The first type is an independent letter of guarantee, which could only be issued by banks and other financial institutions in China. Otherwise, the agreement to exclude the subordination of the guarantee shall be void. The second type is a performance bond. Parties shall make clear agreements on the standard and time of the payment and interest, coordination on the overlap with liquidated damages, etc., to reduce possible disputes. Last but not least, creditors may require the shareholders to serve as guarantors as a means of ensuring the full performance of contractual obligations by the customer.

PRIORITY OF CONSTRUCTION PROJECT FEES

Priority of construction project fees is one of the special priorities constituting the basis of exemption rights. Under EPC contracts, the contractor shall carry out the whole process of design, procurement, construction, and completion acceptance, and be responsible for the quality, safety, construction period, and cost. As such, it is often difficult to crystallize the cost at vari-

ous stages. The contractor has priority right on all the claims in terms of the realization value of the project itself. Notably, the interest, liquidated damages and compensation for damages for overdue construction payments are not included in the priority scope.

CROSS-BORDER INSOLVENCY

Up to now, China has not participated in or concluded any international cross-border insolvency treaties. The recognition and judicial assistance of the overseas insolvency proceedings are limited to the principled guidance in Article 5 of the PRC Enterprise Insolvency Law. On one hand, it has established the basic principle that Chinese insolvency proceedings have an extraterritorial effect on the insolvent's offshore property. On the other hand, the recognition of foreign insolvency proceedings by the courts is based on the principle of reciprocity.

In 2021, the Supreme People's Court and the Government of the Hong Kong Special Administrative Region signed the Record of Meeting of the Supreme People's Court and the Government of the Hong Kong Special Administrative Region on Mutual Recognition of and Assistance to Insolvency Proceedings. Such judicial assistance on a pilot basis was a substantial and constructive step forward in Chinese cross-border insolvency framework.

To sum up, this article focuses on the Chinese enterprise insolvency legal framework for protecting and realizing creditor rights. It intends to provide certain routes and thoughts from the perspective of foreign-invested companies doing business in China as creditors. Foreign corporate creditors need to keep a close watch on domestic customers who may fall into insolvency crisis.



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