

**Cross Border Guide to Restructuring and Insolvency  
(China and Hong Kong)**



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This note is written as a general guide only. It should not be relied upon as a substitute for specific legal advice.

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# The People's Republic of China

## OVERVIEW

This note outlines the various formal insolvency proceedings available in the People's Republic of China (excluding for purposes of this guide, the special administrative regions of Hong Kong and Macao and the territory of Taiwan) ("**PRC**"). It also explains the importance of PRC insolvency related issues including the validity of transactions prior to insolvency, liability of directors and shareholders, employees' benefits, and specific issues related to bankruptcy of financial institutions.

The law is stated as at 19 January 2009

### 1. INTRODUCTION

#### 1.1 Legal Person Enterprise

##### (a) Normal Bankruptcy

The *PRC Enterprise Bankruptcy Law* ("**Bankruptcy Law**") was promulgated by the Standing Committee of the 10th National People's Congress of the PRC on 27 August 2006 and took effect on 1 June 2007. The Bankruptcy Law applies to all types of legal person enterprises (e.g. private-owned enterprises, state-owned enterprises, foreign-invested enterprises and public listed companies) incorporated in the PRC. They were previously separately governed by several different rules and regulations depending on the nature of the enterprise. The basic purpose of the Bankruptcy Law is to protect and balance the interests of enterprises (which are, in many cases, closely connected to interest of the local authorities), their creditors (the majority of which are state-owned banks) and employees, whilst trying to provide a possibility for insolvent enterprises to rescue themselves. Generally, the Bankruptcy Law adopts many concepts (e.g. appointment of administrator, reorganization) widely used in western law systems, but one cannot simply say that the Bankruptcy Law echoes its western counterparts. Maintaining social order is one of the goals of bankruptcy.

Given that the Bankruptcy Law has only recently been enacted, and the need to develop expertise within the judiciary to implement its provisions, there is need for further administrative guidance to be issued before its full effects in practice can be gauged. The bankruptcy of financial institutions, listed companies and state-owned enterprises in practice, will be particularly complex, due to their special nature.

##### (b) Policy Bankruptcy

Since 1994, a separate form of bankruptcy (commonly known as "**Policy Bankruptcy**"), which is mainly regulated under the *Opinions on Improving the Policy-Based Closure and Bankruptcy of State-Owned Enterprises* ("**Policy Bankruptcy Opinions**") and other various rules and policies, has co-existed with the normal form of bankruptcy. The Policy Bankruptcy only applies to the state-owned enterprises ("**SOE**") listed in a bankruptcy schedule of SOEs approved by the State Council. The significant feature of a Policy Bankruptcy is that the bankruptcy will be initiated and led by the authorities, and the interests of the employees may be prior to the claims secured by collateral.

According to the Policy Bankruptcy Opinions, all Policy Bankruptcies will be completed by 31 December 2008, and no new Policy Bankruptcy will be initiated thereafter.

#### 1.2 Non-Legal Person Enterprises and Non-enterprise Entities (i.e. non-profitable entities)

Generally, if any entities other than legal person enterprises go into bankruptcy, the procedures set forth in the Bankruptcy Law can be used for reference. These entities refer to enterprises (mainly, sino-foreign cooperative joint ventures and partnerships<sup>1</sup>) without legal person status and non-enterprise entities (e.g. non-profitable entities such as industry associations, NGOs). There is currently no detailed guideline on how to adopt the Bankruptcy Law for such entities (e.g. how to deal with such entities' capital structure in the event of a bankruptcy).

#### 1.3 Person

In the PRC, there is no concept of personal bankruptcy.

Considering that the Policy Bankruptcy will be outdated soon, this guide will focus only on the bankruptcy proceedings under the Bankruptcy Law. If you are interested in the Policy Bankruptcy, we would like to provide further information at your request.

<sup>1</sup> Sino-foreign cooperative joint ventures and partnerships may also be in the form of legal person.

## 2. INSOLVENCY PROCEDURE

### 2.1 Brief comparison among bankruptcy liquidation, reorganization and compromise arrangement features

	<b>Bankruptcy Liquidation</b>	<b>Reorganization</b>	<b>Compromise Arrangement</b>
Purpose	Liquidate the debtor enterprise (" <b>DE</b> ") and distribute its assets to creditors and shareholders.	Allow the DE to continue operating its business under the supervision of an administrator, suspend creditors to enforce their rights on a temporary basis, and enable creditors to obtain repayment from reorganized DE.	Allow the DE to rescue itself from liquidation through a discounted repayment.
Test	(i) A DE can not repay debts that have fallen due, <u>and</u>  (ii) Its assets are insufficient to pay all of its debts or it manifestly lacks the ability to repay its debts.	(i) Test of bankruptcy liquidation; <u>or</u>  (ii) a DE has manifestly lost the likelihood of being able to repay.	Test of bankruptcy liquidation <sup>2</sup> .
Applicants	(i) <b>Who may apply for bankruptcy liquidation?</b>  DE; or any creditor of the DE.  (ii) <b>Who must apply for bankruptcy liquidation?</b>  Where a legal person enterprise has already been dissolved but has not been liquidated or completed liquidation, and where its assets are insufficient to repay its debts, the liquidation committee must apply for bankruptcy liquidation. <sup>3</sup>	(i) <b>Who may apply directly to the People's Court ("Court") for reorganization?</b>  DE; or any creditor of the DE.  (ii) <b>Who may apply to the court for reorganization, within the period following the date of the Court's acceptance of a bankruptcy petition to the date of declaration of bankruptcy?</b>  (a) if the bankruptcy is applied by a creditor DE; or any investor(s) who has(ve) contributed no less than 10% of the registered capital of the DE  (b) if the bankruptcy is applied by a party other than a creditor  None.	(i) <b>Who may apply directly to the court for a compromise arrangement?</b>  DE.  (ii) <b>Who may apply to the court for a compromise arrangement, within the period following the date of the Court's acceptance of a bankruptcy petition to the date of declaration of bankruptcy?</b>  DE.

<sup>2</sup> Please note that a debtor and a creditor can enter into a compromise arrangement under a civil action which does not require the fulfilment of any tests or thresholds.

<sup>3</sup> Please note that a parent company is not entitled to apply for the bankruptcy of its subsidiary under the Bankruptcy Law. However, under the PRC Company Law, a parent company may initiate the liquidation of its subsidiary. Such liquidation procedure will be converted into the bankruptcy procedure in the event the subsidiary's assets are insufficient to pay its debts upon the petition of bankruptcy by the liquidation committee.

## 2.2 Procedure for Bankruptcy Application

An applicant (please see item 2.1 above) may petition the Court for bankruptcy of the DE. Attached in Schedule 1 is a flowchart which summarises the procedures for making a bankruptcy application.

## 2.3 Organs of Bankruptcy Proceedings

### (a) Court

Bankruptcy cases shall be subject to the jurisdiction of the Court in the place where the DE is registered. Under the Bankruptcy Law, the Court will lead the whole bankruptcy procedure and have the relevant powers, including, appointing an administrator (please see sub-item ((b) below), approving the reorganization plan (even if the reorganization plan is rejected by the creditors' meeting in certain situation) and approving any compromise plan. The Court has relatively broad flexibility compared to the courts in other jurisdictions in exercising their powers due to the lack of detailed regulations and ambiguous wordings under the Bankruptcy Law.

### (b) Administrator

General: In each bankruptcy case, an independent administrator ("**Administrator**") shall be designated. The Administrator will be responsible for management of the DE's assets and business during the bankruptcy proceedings. The Administrator shall report to the Court and accept supervision from the creditors' meeting and creditor's committee.

Appointment: Unlike other jurisdictions, only the Court has the power to appoint an administrator and decide the remuneration of the administrator. The creditors' meeting is entitled to apply to the Court to replace the Administrator if it believes that the Administrator is unable to carry out its duties in an impartial matter in accordance with law, or it is subject to other circumstances rendering it incompetent.

Candidate: An administrator can be a liquidation group, a social intermediary (e.g. a PRC law firm<sup>4</sup>, accounting firm and bankruptcy and liquidation firm), a relevant government official or a professional (e.g. a PRC lawyer, accountant). No one may serve as administrator if it:

- has been subject to criminal punishment for wilful commission of a crime;
- has had its relevant professional practising certificate revoked;
- is an interested party in the case; or
- is otherwise in a circumstance in which it is deemed unfit by the people's court to serve as administrator.

Duties: The duties of an Administrator are similar to those in Hong Kong and England. The administrator shall perform the following duties:

- taking over the assets, seals, books of account, documents and such like materials;
- investigating the DE's assets position and making a report thereon;
- deciding on the DE's internal management matters;
- deciding on the DE's daily outgoings and other required outgoings;
- deciding on whether to continue or cease the DE's operations before holding the first session of the creditors' meeting;
- managing and disposing of the DE's assets;
- participating in lawsuits, arbitrations or other legal proceedings on behalf of the DE;
- making proposals for convening creditors' meetings;
- reporting to the creditors' committee (the Court, in the absence of a creditors' committee), when conducting certain acts which may materially impact on the rights of creditors (e.g. transfer of real estate, mining rights, exploitation rights, intellectual property rights, business, inventory, securities, and loans, borrowings, waiver of any rights, recovering any collateral, performance of outstanding contracts); and
- other duties to be performed by the Administrator, as determined by the Court.

Standard of Remuneration: There is a separate set of rules governing the remuneration of Administrators. For unsecured creditors, this is based on a percentage of the total value of the DE's assets (excluding the value of assets used as collateral) used for repayment of its debts. Generally, depending on the total value of the aforementioned assets, the remuneration for the Administrator ranges from capped amounts of 0.5% to 12% of such total value of assets. For secured creditors, the remuneration ranges from capped amounts of 0.05% to 0.12%, unless otherwise agreed between the secured creditor and the Administrator. A provincial supreme court may further

<sup>4</sup> In China, a representative office of an international law firm is not a PRC law firm.

adjust the maximum ratio downward or upward by no more than 30%, if it believes necessary.

Exit: The duties of the Administrator shall automatically cease the day after completion of the deregistration of the DE with the registration authority (unless there is any pending litigation or arbitration case involving the DE) under the bankruptcy liquidation procedure.<sup>5</sup>

However, the Bankruptcy Law is silent on when the duties of the Administrator ceases in the event of the reorganization or compromise, except that under the reorganization procedure, the monitoring duties of the Administrator will cease upon the submission of the supervision report by the Administrator to the Court after the expiry of the monitoring period.

#### (c) Creditors' Meeting

General: Generally, creditors shall exercise their rights and express their opinions through creditors' meeting and will be bound by the decision passed by the creditors' meeting. The creditors' meeting will be comprised of all creditors who have filed their claims and representatives of employees and the DE's labour union.

Powers and Function: Creditors' meeting shall have the following powers and functions:

- (i) verifying debt claims;
- (ii) applying to the Court to change the Administrator, and examining and reviewing the expenses and remuneration of the Administrator;
- (iii) supervising the Administrator;
- (iv) electing and replacing members of the creditors' committee;
- (v) deciding on continuation or cessation of the business of the DE;
- (vi) adopting reorganization plans;
- (vii) adopting compromise agreements;
- (viii) adopting plans for the management of the assets of the DE;
- (ix) adopting plans on converting the bankruptcy assets into cash at current prices;
- (x) adopting plans for the distribution of the bankruptcy assets; and

- (xi) other powers and functions which should be exercised by the creditors' meeting, as determined by the Court.

Voting Right: Each creditor shall be entitled to vote in the creditors' meeting. However, secured creditors are prohibited from voting on sub-item (vii) and (x) above, unless they waive their priority rights in relation to distribution of the assets. Additionally, creditors whose claims have not been determined cannot exercise their voting right unless the Court temporarily determines the amounts of their claims.

Nevertheless, whether a creditor owning both secured claims and unsecured claims are entitled to vote on sub-item (vii) and (x) above is questionable under the existing provisions.

Voting Mechanism: Generally, a resolution may be passed by more than half of the creditors present at a meeting who hold no less than half of the total unsecured claims. The voting mechanism for reorganization plans and compromise plans are discussed under items 2.10(d) and 2.11(b), respectively.

Creditors' Committee: The creditors' meeting may decide to establish a creditors' committee of no more than nine members (including one representative of the labour union and employees of the DE). All the members of the creditors' committee must be approved by the Court. The major function of the creditors' committee is to supervise the management and disposal of the assets of the DE and the distribution of the bankruptcy assets. The creditors' meeting may also decide to delegate part of its powers to the creditors' committee.

#### 2.4 Priority of Claims/Bankruptcy Assets

All the assets belonging to the DE when the Court accepts the bankruptcy petition and those obtained by the DE during the bankruptcy process are bankruptcy assets. Further, the collateral for secured claims is not excluded from the bankruptcy assets.

##### (a) Principles

The Bankruptcy Law and the interpretation of the Bankruptcy Law issued by the PRC Supreme Court provide three principles (i.e. the General Principle, the Secured Claims Principle and the Existing Employees' Benefits Principle) in relation to the priorities for creditors' claims, each of which operates in parallel with the other. In addition to describing each of the principles, we have also raised below a number of concerns arising from the issue of priority.

<sup>5</sup> Under PRC laws, a company is officially incorporated when registered with the registration authority (similar to a business registrar) which will issue a business license (similar to a certificate of incorporation) to the company.

Below is the summary of each of these principles as provided under relevant laws:

(i) General principle

- bankruptcy expenses.
- public interest debts.
- employees' benefits, which include Existing Employees' Benefits (defined in sub-item (b)(iii) below).
- social welfares and taxes.
- general unsecured bankruptcy debts.
- The type of payments and expenses for each category is further detailed below. If the claims within the same rank can not be fully repaid, they shall be repaid in proportion.<sup>6</sup>

(ii) Secured claims

- A secured creditor has priority over all other creditors as to collateral that has been effectively mortgaged or pledged to it, subject to certain exceptions as outlined below.
- If the Balance of EEB Payments (defined below) is paid in priority to secured claims (see sub-item (iii) below), the secured claims shall have priority over other General Principle claims (other than Existing Employees' Benefits).
- Under the PRC rules related to security, if the collateral is not sufficient to repay the whole secured claim (please see sub-item (c)(i) below), the fee related to realization of security rights shall be repaid prior to the secured principal and interests payments unless otherwise agreed by the security provider and secured creditor.<sup>7</sup>(see sub-item (b)(v) below)
- We have provided a table below summarising the different scenarios and overlaps between claims made under the general principles and secured claims:

Relevant Payment	Will the secured claim have priority over the Relevant Payment?
Bankruptcy expenses	Generally, unclear YES, if the Balance of EEB Payments have been repaid from the collateral.
Public interest debts (generally, including debts incurred post bankruptcy)	Generally, unclear YES, if the Balance of EEB Payments have been repaid from the collateral.
Existing Employees' Benefits	Generally, YES NO for the Balance of EEB Payment, if the Existing Employees' Benefits cannot be fully repaid pursuant to the general principles.
Employees' benefits (excluding Existing Employees' Benefits)	YES
Social welfares and taxes	YES
Unsecured bankruptcy debts	YES

(iii) Employees' benefits incurred before August 27, 2006 ("**Existing Employees' Benefits** ")

- The Existing Employees' Benefits form part of the employees' benefits category and any payments shall first be made in accordance with the general principle. If, following the repayment of the Existing Employees' Benefits pursuant to the general principle outlined above, there remains any balance of payments for Existing Employees' Benefits ("**Balance of EEB Payments**"), the Balance of EEB Payments shall be repaid from the existing collateral in priority to secured claims.

<sup>6</sup> Pursuant to this principle, the Existing Employees' Benefits and other employees' benefits should be repaid in proportion. However, it is questionable whether such "pari passu" principle is still applicable in the event that Balance EEB Payments are to be repaid from the collateral. (see sub-item 0)

<sup>7</sup> Source: clause 74 of Supreme People's Court, Several Issues Concerning the Application of the "PRC, Security Law" Interpretations promulgated on 8 December 2000 and effective as of 13 December 2000.

- In the event, however, there are sufficient assets (excluding collateral) of the DE<sup>8</sup>, the Existing Employees' Benefits cannot assume the priority for repayments set forth in the above paragraph.

(b) Scope of each type of claim

(i) Bankruptcy expenses

The following payments are treated as bankruptcy expenses:

- (1) cost of litigation in relation to the bankruptcy case;
- (2) costs of administration, conversion into cash and distribution of the DE's assets; and
- (3) expenses and fees for the Administrator to carry out its duties, and costs of salaries and of employing its staff, which, generally, includes the fee of the experts (e.g. lawyer, accounting firm, valuation firm) engaged by the Administrator, but exclude that of the experts engaged by the DE or DE's investors or creditors.

(ii) Public interest debts

The following debts are treated as public interest debts:

- (1) debts incurred due to the request by the Administrator or DE to the counterparty to perform the executory portion of the contract<sup>9</sup>;
- (2) debts incurred due to *negotiorum gestio* of the DE's assets<sup>10</sup>;
- (3) debts incurred due to the DE's unjust enrichment<sup>11</sup>;
- (4) remuneration for labour services and social welfare benefit contributions needed for continuing

the DE's business and other debts arising therefrom<sup>12</sup>;

(5) debts incurred due to the damage caused to others by the Administrator or its relevant personnel in the performance of their duties; and

(6) debts incurred due to the damage caused to others by the DE's assets.

(iii) Employees' benefits/Existing Employees' Benefits

Employees' benefits refer to the employees' salaries and expenses of medical treatment, disability allowances and bereavement pensions, outstanding basic pension insurance and basic medical insurance required to be credited into the personal accounts of employees and other compensation which is required to be paid by the DE to employees pursuant to laws and administrative regulations.

Existing Employees' Benefits is part of the employees' benefits and only refer to the employees' benefits owing by the DE prior to the promulgation of the Bankruptcy Law (i.e. August 27, 2006).

(iv) Social welfares and taxes

It refers to any social welfare benefits contributions (excluding those listed in the sub-item (iii) above) and taxes owed by the DE.

(v) Secured Claims related to collateral

It refers to any principal and interest, liquidated damages, compensatory damages, expenses for the custody of collateral and realization of security rights, unless otherwise agreed by the security provider and secured creditor.

(vi) General unsecured bankruptcy debts

It refers to any other debt owing by the DE, including any parts of a secured claim which cannot be fully repaid by the proceeds from the realization of the relevant collateral.

(c) Concerns Regarding Priority of Claims

In relation to the ranking and priority of repayments, the ambiguous provisions of the laws need to be clarified by the relevant authority in the future. Below are the major unclear issues:

(i) the extent to which bankruptcy expenses or public interest debts related to the realization of a

<sup>8</sup> The purpose of this provision is not fully clear. It is questionable whether it may be concluded from this provision that the bankruptcy assets (excluding collateral) shall be used to pay the Existing Employees' Benefits in priority to other employees' benefits, which would be in conflict with the General Principles discussed in the footnote 6 above.

<sup>9</sup> For instance, if the Administrator decides the DE (as the seller) shall continue to perform a sale and purchase agreement, the DE may incur debt from buying the relevant materials or equipments for production. Such debt is covered by this item

<sup>10</sup> Pursuant to *PRC, Civil Law General Principles*, if a party undertakes management or a service without a legal or agreed obligation to do so, in order to avoid harm to the interests of another party, it shall have the right to demand from the benefiting party compensation for the necessary expenses incurred thereby.

<sup>11</sup> Pursuant to *PRC, Civil Law General Principles*, if improper benefits are obtained without legal basis and damage is caused to another party, the illegally gained profits must be returned to the party which suffered such damage.

<sup>12</sup> This clause should be interpreted as any debts incurred in continuing the DE's business, including labour services and social welfare benefit and any other debts. In other words, the post-bankruptcy funding provided for continuing the DE's business should be included. But the Chinese version of this clause is not entirely free from ambiguity, e.g. whether such debts only relate to labour contributions for continuing the DE's business.

particular item of collateral is granted priority over the secured principal and interests against such collateral;

- (ii) In the event the Balance of EEB Payments will be repaid from the realization of collateral (see item 2.4(a)(iii)), and the bankruptcy assets (after payment of the bankruptcy expenses and public interest debts) are sufficient for payment of the Existing Employees' Benefits but not the other employees' benefits, whether under such circumstances the Existing Employees' Benefits repayment is *pari passu* with other employees' benefits repayments in all circumstances, and
- (iii) whether any secured claim has priority over bankruptcy expenses or public interest debts (excluding those related to realization of collateral discussed in sub-item (i) above) at any time, or only when the Balance of EEB Payments have been repaid from the collateral.
- (d) Applicable PRC Laws

Certain PRC Laws (e.g. Article 286 of PRC Contract Law<sup>13</sup>) stipulate that certain types of claims are to be repaid prior to the secured claims. However, it is unclear whether such claims may be repaid prior to bankruptcy expenses, public interests or Existing Employees' Benefits.

(e) Funding

Generally, the funding provided by a third party to the DE once the bankruptcy procedure has commenced should come under the public interest debt category (Please refer to footnote 12). Therefore, funding will be, at least, prior to employees' benefits, taxes and unsecured claims against all the bankruptcy assets (excluding the collateral).

In addition, the debt borrowed by the DE during the bankruptcy procedure is subject to the approval of the Administrator and has to be reported to the creditors' committee (the Court, if there is no creditors' committee)<sup>14</sup>. Therefore, the funding provider should have good grounds to argue that the funding contract (including those provisions related to prior repayment rights) should be enforceable, even if such funding were not recognized as the public interest debt under the Bankruptcy Law.

## 2.5 Procedure for Bankruptcy Liquidation

Attached in Schedule 2 is a flowchart which summarises the procedures for general bankruptcy liquidation.

It is to be noted that certain procedural issues are to be further clarified. For example, it is unclear when the Court shall declare the bankruptcy of the DE in a bankruptcy liquidation procedure, which makes determination of the deadline for application of reorganization or compromise uncertain.

## 2.6 Automatic Stay/Restrictions to Creditors' Right

The Bankruptcy Law imposes an automatic stay on any legal actions/suits upon the acceptance of the bankruptcy by the Court.

### (a) Collection and Repayment

Any individual settlement (including the settlement of secured claims) made, after the Court accepts the bankruptcy petition, between DE and its creditor shall be void.

Secured rights shall be temporarily suspended during the reorganization period from the date on which the Court rules to adopt the reorganization procedure until the termination of the reorganization procedure, *provided that*, the secured creditors may apply to the Court to exercise their secured rights if the collateral may be damaged or its value obviously decreased.

### (b) Civil Suit or Enforcement Procedure

After the Court accepts the bankruptcy petition, (i) any asset preservation (e.g. seizure, freezing obtained outside the bankruptcy process) of the DE's assets must be rescinded; (ii) any enforcement procedures must be suspended; (iii) any civil lawsuits or arbitrations relating to the DE which have started but have not concluded shall be temporarily suspended until the Administrator has taken over the assets of the DE; and (iv) any new civil suits relating to the DE can only be submitted to the Court which has accepted the bankruptcy application (regardless of whether the transaction agreements agreed to by the DE and the counterparty adopts arbitration for any dispute settlement).

<sup>13</sup> Pursuant to this clause, in certain situations, construction fees may be repaid prior to the secured loan against the mortgaged construction project.

<sup>14</sup> If the funding plan is part of the reorganization plan, the approval will also be subject to those required for reorganization plan discussed in item 0 and 0.

## 2.7 Set-off

The Bankruptcy Law provides the possibility for a creditor that owes a debt to the DE to make set-off. If such creditor owes the debt before the bankruptcy application is accepted, it may request the Administrator to set-off it. However, no offsetting may be made in any of the following circumstances:

- the creditor acquires a claim of another party against the DE after the bankruptcy application has been accepted; or
- the creditor becomes indebted to the DE when it already knows the fact of the inability of the DE to discharge debts as they fall due or the bankruptcy application, unless the creditor becomes indebted by operation of law or for a reason that occurred more than one year prior to the bankruptcy application.

The bankruptcy law is silent on (i) whether the Administrator must accept the set-off upon the creditor's request (assuming that there is no exception discussed above, where set-off is prohibited) or the set-off is subject to the sole discretion of the Administrator, (ii) whether the Administrator's decision may be revoked by the Court or the creditors' meeting and (iii) what rights the creditor who applies the set-off or a third-party may have, if the Administrator's decision related to set-off is unfair.

## 2.8 Treatment for Certain Types of Contracts/Actions

### (a) Credit

From the date on which a bankruptcy application is accepted, any credits that have not fallen due shall be deemed to have fallen due and the interest on all credits bearing interest shall cease to accrue.

### (b) Non-fully-performed contract

The Administrator is entitled to decide whether to perform or rescind any outstanding contracts<sup>15</sup> executed prior to the acceptance of the bankruptcy petition, and must notify the counterparty of its decision. If the Administrator decides to continue to perform the contract, the counterparty has the

right to request the Administrator to provide security (the required adequacy of which is not specified by the law). If the Administrator fails to (i) notify the counter party of its decision within two months following the acceptance of the bankruptcy petition or 30 days following the receipt of the counterparty's reminder, or (ii) provide security after the counter party requests security for the contract which it notifies to continue to perform, the Administrator is deemed as to have decided to rescind the contract. The contract will be rescinded and the counterparty is entitled to claim the damages caused by such rescission if the Administrator decides or is deemed to have decided to rescind the contract.

### (c) Void Action

Any actions to (i) conceal or transfer the assets of the DE in order to evade debts or (ii) falsely create a debt or admit to false debts, shall be void.

### (d) Avoidance Actions

Similar to other jurisdictions, the Bankruptcy Law provides a concept of avoidance actions, i.e. fraudulent conveyances and preferences. The court has the power to avoid, upon the request of the Administrator, (i) 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, and (ii) the following events which occur within one year prior to the date the court accepts the bankruptcy petition:

- assigning assets without consideration;
- carrying out a transaction at a manifestly unreasonable price;
- providing asset security over debts which were not previously secured by assets;
- repaying in advance debts that have not fallen due; or
- abandoning its own credits.

## 2.9 Cram-Down

Article 87 of the Bankruptcy Law provides that under certain conditions, a plan of reorganization may be approved notwithstanding the disapproval of a class that is impaired. However, it lacks the power of Section 1129 of the US Bankruptcy Code in that only a DE or Administrator can propose a plan (see section 2.9 below).

<sup>15</sup> The Bankruptcy Law does not specify whether the "contracts" include "labour contracts", which the Administrator can rescind. From common sense, labour contracts should be included in this provision, but, usually, the PRC law will specify "labour contract" (rather than "contract"), if it intends to address it.

## 2.10 Reorganization

### (a) Procedure for Reorganization Procedure

The DE or a creditor may directly petition for a reorganization plan to the Court. Alternatively, after the Court accepts the petition for bankruptcy submitted by a creditor, the DE or any investor(s) who has(ve) contributed no less than 10% of the registered capital of the DE may apply for reorganization before the Court declares the bankruptcy of the DE. Attached in Schedule 3 is a flowchart which summarises the procedures for a reorganization procedure.

Similar to the procedures for a bankruptcy liquidation, there is no specific time limit stated for most of the steps. Therefore, theoretically, the DE may intentionally defer the bankruptcy proceedings by applying and adopting the reorganization procedure.

### (b) Management of the Assets of the DE

The DE is able to manage its assets and operates its assets under the supervision of the Administrator during the reorganization period (if approved by the Court) and the supervision period specified in the reorganization plan.

### (c) Reorganization Plan

A draft reorganization plan should be formulated and presented to the creditors' meeting and the Court for approval by the DE or Administrator. It should address the following matters:

- the DE's business operations plan;
- the categories of creditors;
- the plan for adjusting the debts;
- the plan for repayment of debts;
- the period for implementation of the reorganization plan<sup>16</sup>;
- the monitoring period for the implementation of reorganization plan; and

- other plans which are beneficial to the reorganization of the DE.

The Reorganization Plan cannot reduce the social insurance (excluding those included in the employees' benefits set forth in sub-item 0 above) owed by the DE.

### (d) Voting

All creditors shall be classified into the following voting groups: a secured claims group, an employees' benefits group, a tax group (for tax amounts owed), an unsecured claims group (which may be further separated into an ordinary unsecured claims group and a separate small-sized unsecured claims group determined by the Court<sup>17</sup>), and a capital contribution group (if the reorganization plan involves the adjustment of interests of the shareholders). The reorganization plan shall be approved by each voting group by the approval of more than half of the creditors of that group attending the meeting, which shall represent no less than two thirds of the total claims of that group, subject to the provisions described in paragraph (e) below.

However, certain issues are not clear. For instance, will all the secured creditors or only the secured creditors against the same collateral be included in one voting group? Which group should creditors enjoying the right of priority over the secured creditors (e.g. employees qualified under the Existing Employees' Benefits or creditors qualified under Article 286 of the PRC Contract Law (see Item 2.4(d) above) be classified into? Will the capital contribution group be entitled to vote on the whole reorganization plan or only the matter related to adjustment of interests of shareholders? Will a creditor which owns several different types of claims be entitled to attend all the relevant voting groups or will he/she be limited to voting in one group?

### (e) Court's Power

The reorganization plan shall be reviewed by the Court after each voting group approves the plan. However, even if the reorganization plan is rejected by any or all of the voting groups, such reorganization plan may still be adopted pursuant to the approval of the Court if the Court believes that the reorganization plan conforms to the standards set forth in the Bankruptcy Law. Generally, those standards are

- the secured claims will be repaid in full out of the realization of the collateral, the employees' benefits and taxes will be fully repaid, the proportion of repayment of unsecured claim will be not lower than that projected in the bankruptcy liquidation procedures, the adjustment to interests of capital contribution is equitable and fair;

<sup>16</sup> It is unclear why there are two different periods for implementation and monitoring respectively.

<sup>17</sup> Which amount of claim should be classified as the small-sized is subject to the discretion of the Court based on specific situations.

or the corresponding voting group has already approved the reorganization plan;

- the reorganization plan treats members of the same group fairly, and the repayment priority order does not violate the general principal set forth in item 2.4(a) above); and
- the debtor's operating plan is feasible.

(f) Effectiveness of the Reorganization Plan

The reorganization plan approved by the Court shall be binding on the DE and all the creditors of the DE (including those creditors who do not submit the claim to the Court or attend the meeting, or reject the plan in the meeting). If the reorganization plan is fully performed, upon the completion of the reorganization plan, the DE will not be liable for those debts reduced or waived by the reorganization plan.

2.11 Compromise

(a) Procedure for compromise arrangement

The DE may petition for a compromise arrangement to the Court (i) before the bankruptcy procedure is initiated or (ii) after the Court accepts the petition for bankruptcy but before the Court declares the bankruptcy of the DE. Attached in Schedule 3 is a flowchart which summarises the procedures for the compromise procedure.

(b) Unsecured Creditors' Approval / Secured Creditors' right

The compromise plan shall be approved by the consent of more than half of the creditors of attending the meeting, which shall represent no less than two thirds of the total unsecured claims. The plan approved by the creditors' meeting shall be subject to the final review of the Court.

As discussed in item 2.3(c) above, the secured creditors are not entitled to vote on the compromise plan. The secured creditors are entitled to exercise their rights upon the Court issues a compromise ruling - i.e. the secured creditors will not need to wait for the negotiation, approval and implementation of the compromise plan.

(c) Effectiveness of the Compromise Plan

Similar to the reorganization plan, the compromise plan approved by the Court shall be binding on the DE and all the creditors of the DE (including those creditors who do not submit the claim to the Court or attend the meeting, or reject the plan in the meeting). If the compromise plan is

fully performed, upon the completion of the compromise plan, the DE will not be liable for repayment.

### 3. BANKRUPTCY OF FINANCIAL INSTITUTIONS

The financial institutions (e.g. commercial banks, securities companies, insurance companies) are also subject to certain special requirements beside those applicable to the enterprises discussed above.

(a) Application for bankruptcy liquidation

In addition to the applicant listed in item 2.1 above, the State Council's financial regulatory authority may apply to the Court for reorganization or bankruptcy liquidation.

(b) Declaration of bankruptcy of commercial banks, securities companies and insurance companies

Declaration of bankruptcy of commercial banks, securities companies and insurance companies by the Court are subject to pre-approval of the relevant regulatory authorities.

(c) Priority of Repayment

Generally, the debts owing to the general public will be ranked relatively higher compared to the rankings in the bankruptcy of ordinary enterprises. For instance, in the case of bankruptcies of insurance companies and commercial banks, the compensation, principal and interest payments of individual depositors (as the case may be) shall be prior to taxes and debt payments of the DE.

(d) Control

When the State Council's financial regulatory authority seizes control of or places in trust a financial institution facing severe operational risks, the authority is entitled to commence civil litigation proceedings or enforcement procedures in which the financial institution is the defendant or the party subject to enforcement.

As of date, the rules related to bankruptcy of financial institutions are promulgated before the promulgation of the Bankruptcy Law. The content of those rules are not fully consistent with the Bankruptcy Law and may cause additional uncertainties in relation to bankruptcy proceedings. According to information from public

sources, the PRC authorities are drafting new rules relating to bankruptcy of financial institutions.

#### 4. LIABILITIES OF DIRECTORS

The Courts may investigate and determine the liabilities of directors if there is any breach of directors' duties contributing to the DE becoming bankrupt. Directors owe fiduciary duties to the company and under the PRC Company Law, he/she cannot engage in certain acts which include misusing company funds, depositing funds owned by the company in an account in his own name or in another person's name, and lending company funds to others, or using company funds to provide security to others in breach of the provisions of the company's articles of association, and without the consent of the shareholders' general meeting, the shareholders' meeting or the board of directors.

Any violation leading to the DE becoming bankrupt will result in the director having to assume civil liability with respect to the bankrupt entity pursuant to Article 125 of the Bankruptcy Law - i.e. he/she may be ordered to contribute assets in bankruptcy.

Where the DE commits certain acts stipulated under the Bankruptcy Law affecting the interests of creditors, the DE's legal representative and other directly responsible personnel which may possibly include directors shall be liable to pay compensation. Such acts include concealing or transferring the assets in order to evade debts, falsely creating a debt or admitting to false debts, or during the one year period prior to the Court accepting a bankruptcy application, either assigning assets for no consideration carrying out a transaction at an obvious undervalue, providing asset security over debts which were not previously secured by assets, or repaying in advance debts that have not fallen due.

Criminal liability may also be attached to directors in the event the violation constitutes a crime under the *People's Republic of China Criminal Law ("Criminal Law")* - i.e. the crimes of "interference with liquidation" and "committing illegal acts for personal gain or by fraudulent means resulting in bankruptcy or losses". The criminal penalty for the former include a fine of between RMB20,000 and RMB200,000 and a fixed term of imprisonment (five years or less), whilst the latter only includes a fixed term of imprisonment (three years or less).

Further, under the Company Law, directors who are found personally liable are restricted from taking up the positions of a director, supervisor or senior management personnel of a company within 3 years from the date of completion of the insolvency procedures.

There is also a catch all provision under the Company Law - i.e. where a director or supervisor or senior manager acts in breach of the provisions of laws, administrative regulation or the company's articles of association when carrying out their duties, they are liable to compensate the company for any losses caused.

#### 5. LIABILITIES OF THE SHAREHOLDERS

Shareholders of a limited liability company are generally shielded from liability. However, under the Bankruptcy Law, after the Court has accepted a bankruptcy application, where any shareholder of the DE has not fully paid its capital contributions, the administrator will request such shareholder to make its contribution, regardless of any time limit on the period for capital contributions. Shareholders should also take note that under the PRC Company Law, a shareholder who fails to make a capital contribution is also liable for breach of contract to those shareholders who have made their agreed capital contributions in full, in addition to his obligation to make his capital contribution in full to the company.

In saying the above, separate from the Bankruptcy Law and under the PRC Company Law regime, the PRC Supreme Court has also provided under Articles 18 and 19 of the *Rules of the Supreme Court for Certain Issues Relating to the Application of the Company Law of the People's Republic of China II* for certain scenarios whereby shareholders may be liable for more than their contributions (note that the following also applies to directors):-

- (a) where the shareholders fail to form a liquidation group within the statutory time limit resulting in losses or damages to the DE's properties, and any creditors subsequently bring a claim against such shareholders, the Courts will consider such claims;
- (b) where the shareholders delay in fulfilling their obligations resulting in losses to the main properties, accounts and documents of the DE and also the failure to properly conduct the liquidation process, where any creditors subsequently bring a claim against such

shareholders, the Courts will consider such claims; and

- (c) where the shareholders maliciously dispose of company properties causing losses to any creditors of the company following the dissolution of the company, failure to properly conduct the liquidation process of the DE or improper de-registration by submission of false reports, where any creditors subsequently bring a claim against such shareholders, the Courts will consider such claims.

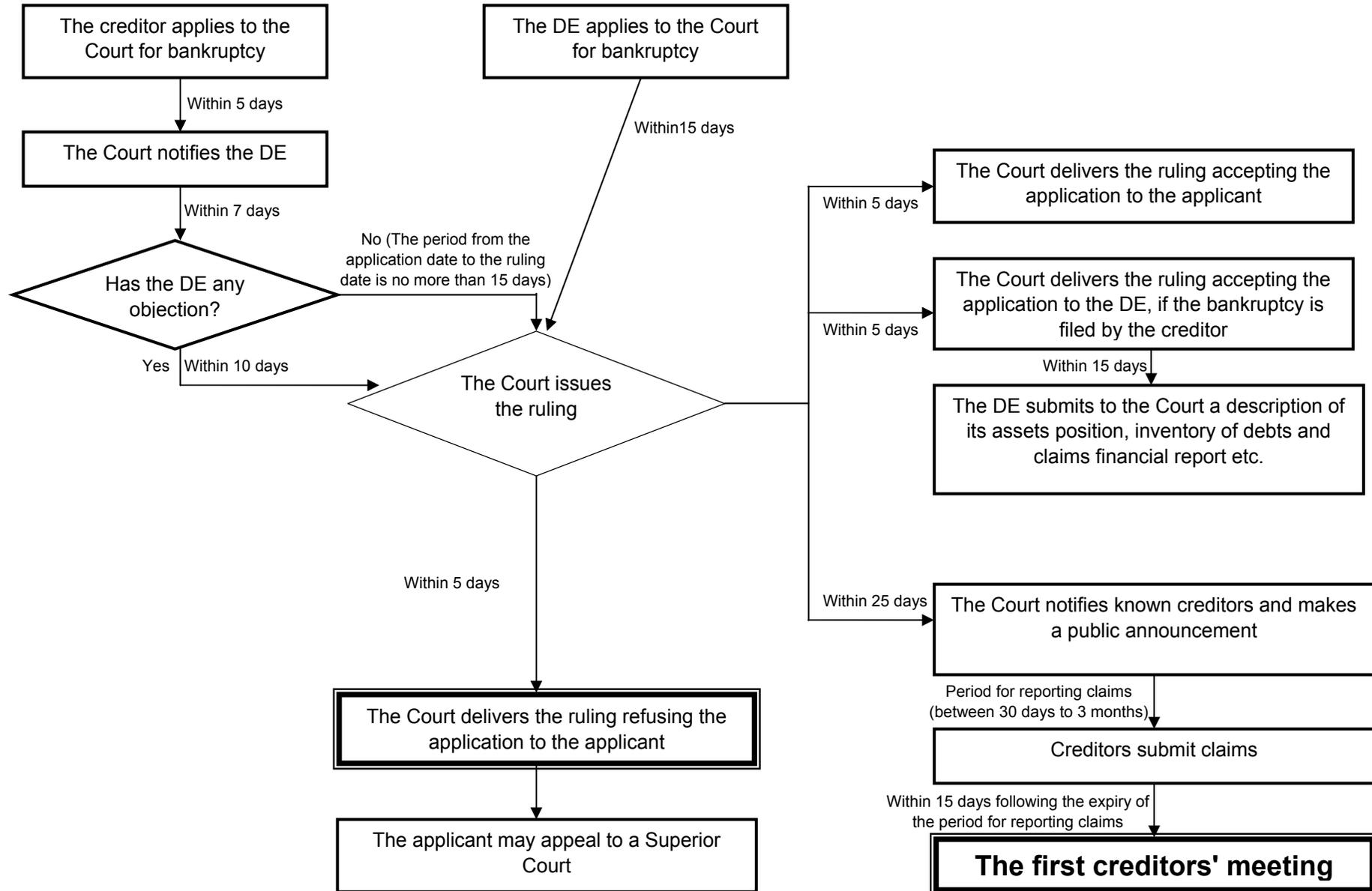
Note that the interplay between the PRC Company Law and Bankruptcy Law is not certain.

## 6. CROSS-BORDER RECOGNITION

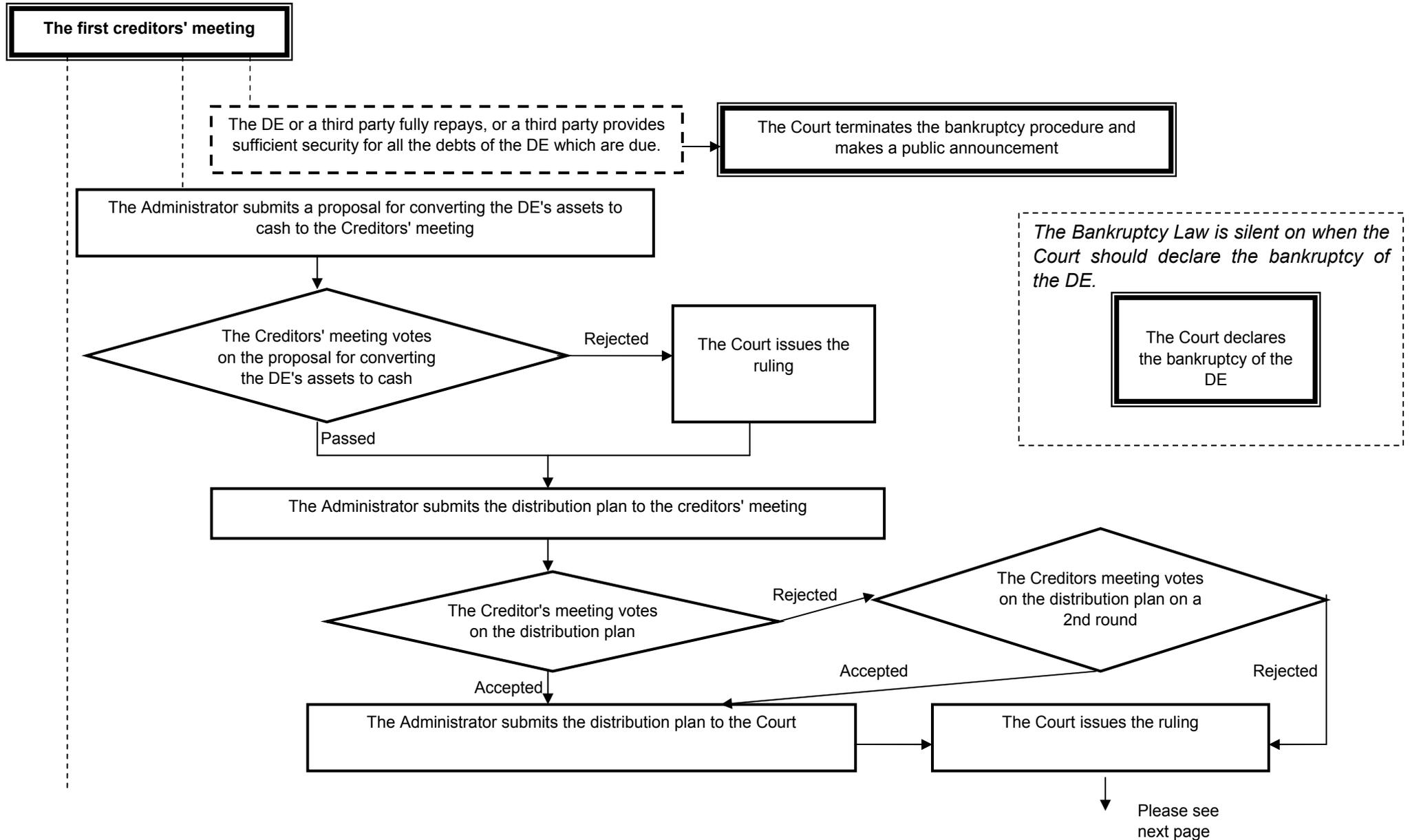
Depending on the source of the foreign insolvency procedure, the Bankruptcy Law allows for an overseas liquidator to seek recognition in China of an overseas court judgment or arbitral award relating to insolvency procedures involving PRC assets. The same applies to a PRC party seeking to enforce a PRC court issued judgement in a foreign country in which the assets are located. This is subject to (i) the court having the jurisdiction to pass a judgment on the relevant entity and (ii) the judgment being covered under an international bilateral or multilateral treaty to which China is a party, or on the basis of reciprocity between the relevant country and China. China has entered into judicial co-operation treaties in civil and commercial matters with approximately 40 other countries (excluding the United States and the United Kingdom), each of which has a defined scope of co-operation between the two countries. In order to determine if cross border recognition of insolvency procedures with a particular foreign jurisdiction is recognised, the parties will need to examine the scope of the treaty and apply for recognition and enforcement.

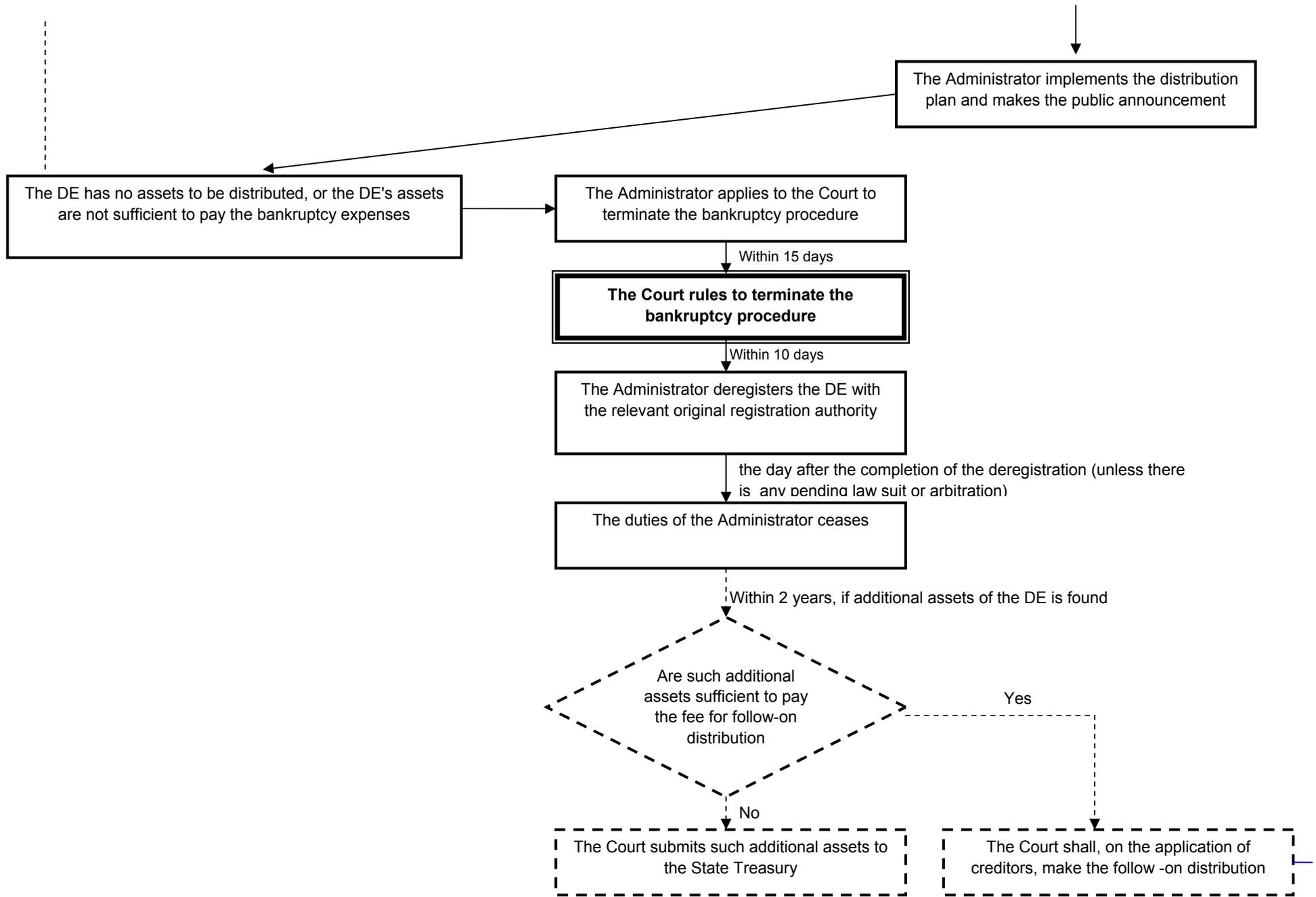
In all cases, recognition is also subject to the Court determining that such recognition would not violate the basic principles of Chinese law, damage Chinese sovereignty, security or social public interests or damage the public interests of China or those of Chinese creditors.

**SCHEDULE 1  
PROCEDURES FOR BANKRUPTCY PETITION**

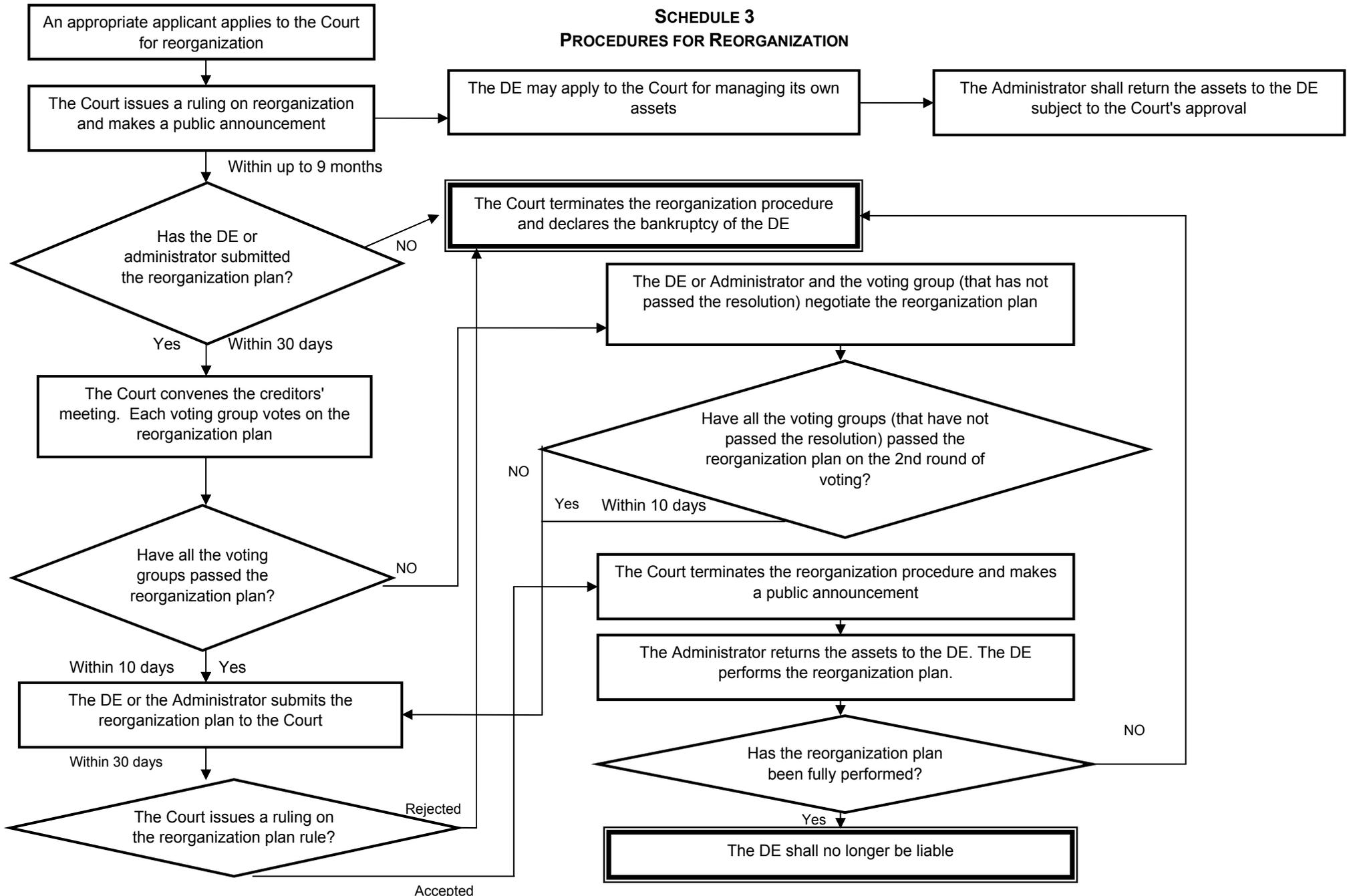


### SCHEDULE 2 PROCEDURES FOR BANKRUPTCY LIQUIDATION

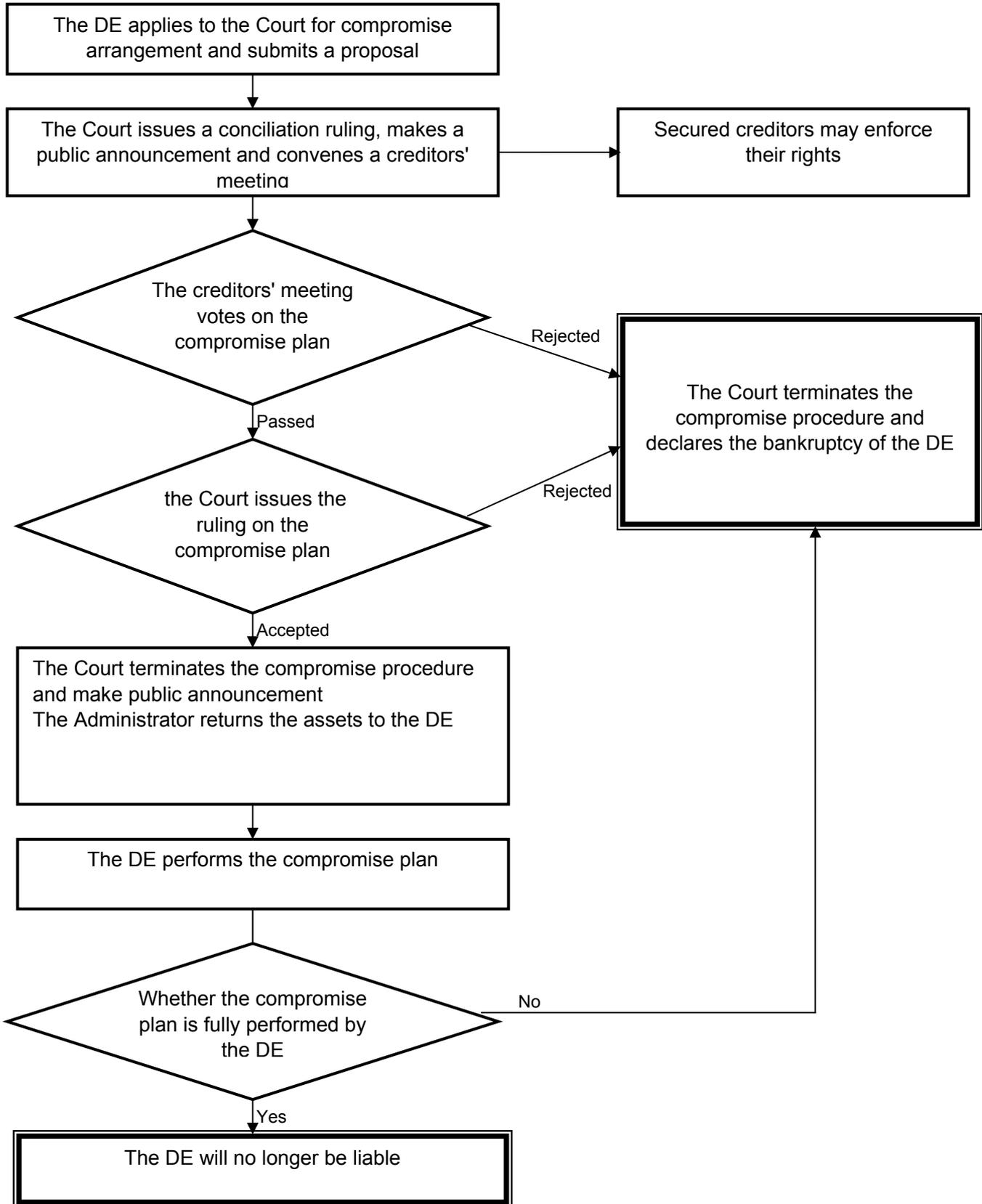




### SCHEDULE 3 PROCEDURES FOR REORGANIZATION



**SCHEDULE 4  
PROCEDURES FOR COMPROMISE ARRANGEMENT**



# Hong Kong

## HONG KONG

### 7. OVERVIEW

Hong Kong's insolvency regime is largely based on historical legislation from the United Kingdom which emphasizes the realisation of assets for the benefit of creditors rather than the rescue and rehabilitation of companies. The legislation concerning corporate insolvency is contained primarily in the Companies Ordinance and the Companies (Winding-up) Rules. Certain provisions of Bankruptcy Ordinance (and the related Bankruptcy Rules) are also applicable in the liquidation of insolvent companies.

### 8. INDIVIDUAL BANKRUPTCY OPTIONS

#### 8.1 Creditor's Petition

A bankruptcy petition is filed at Court and served on the debtor. If the petitioning creditor is a secured creditor, he must in his petition either state that he is willing to give up his security for the benefit of all creditors in the event of the debtor being adjudged bankrupt, or give an estimate of the value of his security and state that the petition is made in respect of the unsecured part of the debt (section 9, Bankruptcy Ordinance).

#### 8.2 Debtor's Petition

A debtor can also present a petition himself on the ground that he is unable to pay his debts. The petition must be accompanied by a statement of the debtor's affairs containing the particulars of his creditors, debts, liabilities and assets. There is no minimum amount of money required to be owed before the petition can be presented (section 10, Bankruptcy Ordinance).

### 9. CORPORATE INSOLVENCY/RESTRUCTURING OPTIONS

#### 9.1 Creditors' Voluntary Liquidation

Voluntary liquidation is initiated by the company itself. It is relatively straightforward process, and the Court is not involved other than in giving directions to the affected parties, upon their application, in the event of any matters of contention.

A board meeting has to be held to convene an extraordinary general meeting of the company, which is followed by a meeting of creditors. At the extraordinary

general meeting, the members must pass a special resolution (by a majority of 75%) to wind up the company and to appoint a liquidator. A voluntary liquidation is deemed to commence on the date on which the special resolution is passed (section 233(4), Companies Ordinance).

Creditors are given an opportunity to question the directors at the meeting before proceeding to consider the members' appointment of liquidator. The creditors may nominate their own choice of liquidator, and if the creditors' nominee is different to that of the members, the creditors' choice prevails.

#### 9.2 Members' Voluntary Liquidation

When a voluntary liquidation is proposed, the directors or a majority of them may, at a meeting of the directors, issue a certificate in the specified form ("certificate of insolvency"):

- (a) they have a full inquiry into the affairs of the company; and
- (b) they have formed the opinion that the company will be able to pay its debts in full within a maximum of 12 months from the commencement of winding up (section 233, Companies Ordinance).

The declaration must be made within the five weeks preceding the passing of such a resolution, or on the day of the resolution but before the resolution is passed, and must be delivered to the Registrar for registration. A statement of the company's assets and liabilities as at the latest practicable date before the certificate is made must be attached to the declaration. The liquidator is appointed by the company in general meeting.

#### 9.3 Voluntary Liquidation under Section 228A of the Companies Ordinance

In addition to the above, a company can be wound up voluntarily by special procedure if the directors of the company, or the majority of them, make and deliver to the Registrar a statement in the specified form (known as the "winding-up statement") under section 228A of the Companies Ordinance, recording their resolution that it cannot by reason of its liabilities continue its business and that it is advisable to be wound up. The directors must also certify that it is not reasonably practicable for the winding up to be commenced in another manner.

The voluntary liquidation is deemed to commence when the winding-up petition is delivered to the Registrar (section 228A(5)(a), Companies Ordinance), and the petition must also be advertised at least once in the Hong Kong Government Gazette and once at least in two Hong Kong daily newspapers seven clear days before the hearing (rule 24, Companies (Winding-Up) Rules). The directors must appoint a provisional liquidator and convene meetings of the company's creditors and members within 28 days of the delivery of the declaration (section 228A(5)(b),(c), Companies Ordinance).

In practice, liquidations under section 228A are rarely used.

#### 9.4 Compulsory Liquidation

This is often the last resort of an unpaid creditor, who is seeking payment and who is prepared to assert that the debtor is insolvent.

A petition may be presented to the Court by the company, its creditors, its members, the Financial Secretary, the Registrar of Companies, or the Official Receiver, together with the petitioner's affidavit. A sum of HK\$12,150 must be deposited with the Official Receiver's Office. A compulsory liquidation is deemed to commence on the date on which the petition is presented, even though the winding up order will not be made until later.

There are six main grounds for compulsory liquidation, as follows:

- (a) the company has by special resolution resolved that the company be wound up by the Court;
- (b) the company has not commenced its business within a year from its incorporation, or suspends its business for a whole year;
- (c) the company has no members;
- (d) the company is 'unable to pay its debts;'
- (e) the event, if any, occurs of the occurrence of which the memorandum or articles of association provide that the company is to be dissolved; or
- (f) the Court is of the opinion that it is just and equitable that the company should be wound up (section 177, Companies Ordinance).

The vast majority of compulsory winding ups will be on account of the company's insolvency, or, as section

177(1)(d) of the Companies Ordinance more precisely requires, that it is established that the company is 'unable to pay its debts'. Fortunately, the Companies Ordinance (section 178(1)) provides a number of relatively straightforward ways by which a creditor can establish that a company is 'unable to pay its debts'. Most commonly, this is by a creditor serving a statutory demand on the company (for an undisputed debt). If, after 21 days, the demand remains unsatisfied, the creditor can proceed to present a petition to have the debtor company wound up.

#### 9.5 Receivership

A receiver is a person, normally an insolvency practitioner, appointed to take possession of specific property to safeguard it, to receive income from it or to dispose of it. Where the receiver takes control of the general conduct of a business (including assets), he is called a receiver and manager. A receiver does not wind up or liquidate the company.

Receivers are usually appointed under debentures or charge documents granted in favour of a bank, as security for lending or general banking facilities, after the customer fails to repay the loans as demanded by the banks. The debenture may incorporate charges on specific property (fixed charge) or the general business undertaking of a company (floating charge) under the Companies Ordinance. The security afforded to the debenture holder may therefore be a fixed charge, a floating charge or a combination of both.

The Court may appoint a receiver, for example, to safeguard property, which is the subject of a dispute or pursuant to a charge order in debt recovery actions.

The receiver's primary duty is to the debenture holder who appointed him and his task is to realise sufficient assets to pay off the debt due to his appointee. Where the appointment is under a floating charge, or a charge originally created as such, the receiver would need first to settle the claims of preferential creditors, who take precedence over the floating charge debenture holder.

Whilst the receiver is not appointed by the general body of creditors and he does not have any statutory responsibility to call meetings of creditors or to account to them for his administration, a receiver should nonetheless have regard to the possible interest of the unsecured creditors in disposing of the assets under the charge. As a matter of professional courtesy and particularly where the receiver is attempting over a prolonged period of time to dispose of

the business as a going concern, he may wish to retain the goodwill and cooperation of the general body of creditors by issuing to them periodic reports of the progress of the receivership.

If there are surplus funds after payment to the debenture holder, these should be returned to the company or passed to any liquidator appointed. The receiver would not be paying any dividends to unsecured creditors in any case.

The appointment of receivers (and managers) can help preserve the value of the secured assets of a business, thereby protecting the interests of the secured lenders and result in the disposal of the business as a going concern, if possible, thus enhancing the return for secured lenders.

## 9.6 Scheme of Arrangement

A scheme of arrangement is a statutory mechanism for a contractual arrangement between a company and its creditors that enables a restructuring of debt or a binding compromise to be put in place which is agreed by way of resolutions passed at meetings of classes of creditors.

Schemes of arrangement are governed by section 166 of the Companies Ordinance. They are a corporate restructuring tool which enables a company to make a compromise arrangement with its creditors and members, which if approved by the Court is legally binding. Arrangements may include variations of contractual terms, for example, freezing of payment of interest or capital, exchanges of debt for equity in related companies or payment to unsecured creditors to compromise debts outstanding.

The Court has an ultimate discretion whether to sanction any scheme of arrangement and will consider whether the requirements of the Companies Ordinance have been complied with, whether the majority proposing the scheme is acting *bona fide* and if the arrangement is fair to all creditors in the circumstances. If there are different classes of creditors, for example, contingent or unsecured, each class is required to hold separate meetings to discuss the proposals.

The advantage of a scheme is that application can be made to the Court if the scheme is approved by a majority of the creditors or a class of them (50% of the creditors in number and 75% of the creditors of that class in value attending the creditors meeting) and will be binding on all creditors of that class if sanctioned.

It is not as effective as Chapter 11 as secured creditors retain veto power over the restructuring process because there is no mechanism to compel an unwilling secured creditor to agree to any modification of its contractual rights. The scheme also does not bind actions of future creditors who may commence action against the company. In this regard, the scheme provisions in the Companies Ordinance do not provide for a general stay of claims against the debtor while the scheme is being considered and voted upon.

## 10. APPLICATION FOR STAY OF PROCEEDINGS

### 10.1 Individual Bankruptcy

The Court may at any time, for sufficient reason, make an order staying the proceedings under a bankruptcy petition, either altogether or for a limited time, on such terms and subject to such conditions as the Court may think fit (section 104 of the Bankruptcy Ordinance).

### 10.2 Corporate Insolvency

Section 186 provides that, once a winding-up order has been made or a provisional liquidator has been appointed, no action or proceeding shall be proceeded with or commenced against the company or its property. Section 186 is subject to the leave of the Court, which can impose conditions.

Section 209 of the Companies Ordinance provides that at any time after making a winding up order, the Court may, on the application of the liquidator, the Official Receiver, or any creditor or contributory, and on proof that all the proceedings in relation to the winding up ought to be stayed, make an order staying the proceedings, either altogether or for a limited time, on such terms and conditions as the Court thinks fit. Before making any order, the Court may require the Official Receiver to furnish the Court with a report.

## 11. COMMENCEMENT OF BANKRUPTCY AND WINDING-UP

### 11.1 Individual Bankruptcy

The bankruptcy of a debtor commences on the day on which the bankruptcy order is made and continues until the order is discharged (section 30, Bankruptcy Ordinance). However, certain dispositions of property made after the filing of the petition, or within certain periods before the date of the order, may be set aside.

## 11.2 Corporate Insolvency

A compulsory winding up is deemed to commence at the time the petition is presented to the Court (section 184(2), Companies Ordinance). A voluntary winding up is deemed to commence either when the resolution is passed (section 230, Companies Ordinance) or in the case of a winding up under section 228A of the Companies Ordinance, when the statutory declaration is delivered to the Registrar (section 228A(3), Companies Ordinance).

## 12. VOIDABLE TRANSACTIONS

### 12.1 Individual Bankruptcy

- (a) Where a bankruptcy order is made against the debtor, any disposition of property made by the debtor from the day of the presentation of the petition in bankruptcy to the time when the property is vested in the trustee of the bankrupt's estate is void, unless it was made with the consent of the Court or was subsequently ratified by the Court (section 42(1), (2) and (3), Bankruptcy Ordinance).

However, a debt incurred after the bankruptcy order by the making of a payment (e.g. where the debtor's bank makes a payment on his behalf) will nevertheless be deemed to have been incurred before it, and thus is not void if the creditor had no notice of the bankruptcy and it is reasonably practicable to recover the amount of the payment (section 42(5), Bankruptcy Ordinance).

- (b) A transaction, made at an undervalue within five years before the day of the presentation of the bankruptcy petition and by a person adjudged bankrupt, may be reversed. The Court may on application make an order to restore the position to what it would have been if the bankrupt had not entered into that transaction (sections 49 and 51(a), Bankruptcy Ordinance). A transaction will be considered to be made at an undervalue if it is a gift, if it is entered into in consideration of marriage, or if it is for a consideration which is of significantly lower value than the value provided by the bankrupt.
- (c) A transaction which is an "unfair preference", but not a transaction at an undervalue, may also be reversed by the Court if made within six months before the date of the bankruptcy petition. The

period of six months is extended to two years in cases where the preference is given to an "associate" of the bankrupt (sections 50 and 50(1)(b), Bankruptcy Ordinance). The Court may on application make an order to restore the position to what it would have been if the bankrupt had not entered into that transaction.

For these purposes, a bankrupt will be deemed to have given an "unfair preference" if such other person is one of his creditors, or a surety or guarantor for any of his debts or liabilities, and the adjudged bankrupt did or permitted to be done something which put that creditor, surety or guarantor in a better position than that in which he would have otherwise been; but no order can be made by the Court unless the bankrupt was influenced in deciding to give the preferential treatment by a desire to put the relevant person in a better position. A person is an "associate" of the debtor if that person is the debtor's spouse, relative, partner, trustee, controlled company, etc. (section 51B, Bankruptcy Ordinance).

- (d) An extortionate credit transaction can be set aside if entered into within three years before the commencement of the bankruptcy, and if, having regard to the risk accepted by the person providing the credit, the terms required grossly exorbitant payments to be made in respect of the provision of the credit or the transaction grossly contravened ordinary principles of fair dealing (section 71A, Bankruptcy Ordinance).

### 12.2 Corporate Insolvency

- (a) In a winding up by the Court, any disposition of the property of a company and any transfer of shares, or alteration in the status of the members of the company, which is made after the commencement of the winding up, is void unless the Court otherwise orders (section 182, Companies Ordinance).

When a company is being wound up by the Court, any attachment, sequestration, distress, or execution put in force against the estate or effects of the company after the commencement of the winding up is also void (section 183, Companies Ordinance).

(b) Any act relating to property (including any conveyance, mortgage, delivery of goods, payment or execution) made or done by or against a company within six months before the commencement of its winding up is deemed a fraudulent preference of its creditors and invalid if it would have been so in the context of an individual's bankruptcy. The six month period is extended to two years in respect of any transaction with an "associate" of the company (sections 266 and 266B, Companies Ordinance).

(c) A floating charge on the undertaking or property of the company created within the 12 months prior to the commencement of the winding up shall, unless it is proved that the company immediately after the creation of the charge was solvent, be invalid, except as to the amount of any cash paid to the company at the time of or subsequent to the creation of, and in consideration for, the charge, together with interest on that amount at the rate specified in the charge or at the rate of 12 per cent per annum (whichever is less) (section 267, Companies Ordinance).

In addition, to the extent that the assets available for creditors are insufficient to pay the claims of preferred creditors in full, the preferred creditors take priority over any charge which was originally created as a floating charge and are paid out of the property subject thereto (section 265(3B), Companies Ordinance).

(d) The liquidator of the company is entitled to disclaim certain onerous property of the wound up company, including land burdened with onerous covenants, shares or stock in companies, and unprofitable contracts with the leave of the Court at any time within 12 months after the commencement of the winding up or such extended period as may be allowed by the Court (section 268, Companies Ordinance).

(e) Further, where the company is being wound up and is or has been a party to a transaction for or involving the provision of credit to the company, and the credit is regarded as extortionate with regard to the risk accepted by the person providing the credit (i.e. where grossly exorbitant payments are required to be made by the

company or the transaction grossly contravenes ordinary principles of fair dealing), the liquidator of the company is also entitled to apply to the Court for an order setting aside the whole or part of the extortionate credit or to vary the terms of the transaction (section 264B, Companies Ordinance). Once such an application is made, the onus is on the counterparty to show that the transaction was not extortionate.

### 13. DISTRIBUTION OF PAYMENTS

#### 13.1 Compulsory Winding Up

The ranking of creditors partly depends on the circumstances of each case. However, the general order of priority is:

- (a) **secured creditors** are secured by fixed charges or mortgages are paid (less the cost of realisation) from the proceeds of the charged assets;
- (b) **liquidation costs** which includes the liquidator's fees, the costs of winding-up petitions and costs of realisations (Rule 179 of the Companies (Winding-up) Rules), which may be varied by the Court pursuant to section 220 of the Companies Ordinance if the company's assets are insufficient to meet the costs, charges and expenses incurred in the winding up;
- (c) **preferential creditors** are given priority over unsecured creditors under section 265 of the Companies Ordinance. These debts can be roughly organised into the following categories of priorities:
  - (i) for employees' claim;
  - (ii) for statutory debts owed to the Hong Kong SAR Government, including tax claims for taxes due and payable within the 12 months preceding the date of the appointment of a provisional liquidator, or, if no such appointment has been made, the date of the winding up order;
  - (iii) for small deposits of up to HK\$100,000, where the company being wound up is a bank; and

(iv) for various insurance-related claims, where the company being wound up is an insurer.

(d) **floating charge holders** are paid from the sale of proceeds of a floating charge and if these are not sufficient to pay the debt, the creditor can claim the balance as an unsecured creditor;

(e) **unsecured creditors** rank equally for payment and are paid on a proportional basis if there are insufficient assets to meet their claims in full; and

(f) **shareholders**, if there are any remaining assets.

### 13.2 Creditors' Voluntary Winding Up

The situation is generally the same as for compulsory winding ups. Section 250 of the Companies Ordinance provides that the general principle for the distribution of the property of a company in a voluntary winding up is subject to (a) the *pari passu* satisfaction of the claims of the creditors and (b) distribution among the members according to their rights and interests in the company. Section 265 of the Companies Ordinance applies to voluntary winding ups. Rule 179 of the Companies (Winding-up) Rules technically does not, although in practice it is applied by analogy.

### 13.3 Scheme of Arrangement

The order of priority would be a matter for the scheme or the proposal of the voluntary arrangement, but in practice it will usually follow the statutory regime in order to meet fairness requirements.

## 14. LIABILITY OF DIRECTOR

14.1 If, in the course of the winding up of a company, it appears that any business of the company has been carried on with intent to defraud creditors of the company, on application of the liquidator, any creditor or contributory or the Official Receiver, the Court may declare that any persons who were knowingly parties to the carrying on of the business in the above manner shall be personally liable for all or any of the debts or other liabilities of the company, as the Court may direct (section 275, Companies Ordinance). In any event, all such persons are guilty of a criminal offence and are liable for imprisonment and a fine. Further, the Court can also make a disqualification order

against that person (in respect of other corporate directorships), the maximum period of which is 15 years (section 168, Companies Ordinance).

14.2 In addition, the Court may make a disqualification order against a person on application if it is satisfied that he is or has been a director of a company which has at any time become insolvent, whether while he was a director or subsequently, and that his conduct as a director of that company, either taken alone or taken together with his conduct as a director of any other company or companies, makes him unfit to be concerned in the management of a company (section 168H(1), Companies Ordinance).

## 15. CROSS-BORDER INSOLVENCY

15.1 Hong Kong law does not currently recognise the United Nations Commission for International Trade Law's Model Law on Cross-border Insolvency. However, the approach taken by the Courts to cross-border insolvency issues has been fairly pragmatic and the Courts will recognise foreign liquidations and have regard to foreign restructuring arrangements which have been approved overseas when considering what steps should be taken in Hong Kong. It is generally accepted that although the Court retains a discretion the Court will recognise a judicially sanctioned foreign corporate debt-restructuring scheme in order to prevent a creditor from gaining an unfair advantage over other creditors who observe such a scheme.

15.2 Where there are a number of liquidations in different countries, the Courts encourage them to agree a cross-border protocol for dealing with assets of the company and claims by creditors. The need for intervention by the Courts will also be considered if Hong Kong is not the main jurisdiction for winding-up. If, for example, there are no assets in Hong Kong and the Order is unlikely to be of benefit to any creditors an Order may not be appropriate.

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