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### **Measures for Registration of Pledges for Equity Interest**

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## **Analysis of China's New Bankruptcy Law**

After 12 years of drafting and deliberation, the Standing Committee of the 10th National People's Congress (NPC) of the People's Republic of China (PRC) passed the Law of the PRC on Enterprise Bankruptcy (New Bankruptcy Law) on 27 August 2006. When the New Bankruptcy Law took effect on 1 June 2007, it replaced the old Enterprise Bankruptcy Law, a Trial Implementation which was passed in 1986 (1986 Bankruptcy Law). With 12 chapters and 136 articles, the New Bankruptcy Law is far more comprehensive than the 1986 Bankruptcy Law, which had only six chapters and 43 articles, and which was labeled a "trial" measure when it was issued. While more than one year has passed since the enforcement of the New Bankruptcy Law, it is still worthwhile to examine some of the breakthroughs of this law, especially in light of recent global economic turmoil.

### **Comparison Between the New Bankruptcy Law and the 1986 Bankruptcy Law**

#### *Widening of Applicability*

The 1986 Bankruptcy Law applied only to state-owned enterprises (SOES), but the New Bankruptcy Law comprehensively applies to all entities that hold legal person status (Article 2 of the New Bankruptcy Law), even with regard to financial institutions, such as commercial banks, insurance companies and securities companies. The relevant authority of the State Council may apply for financial institutions' restructuring or bankruptcy according to the New Bankruptcy Law or other relevant laws (Article 134). In addition, the New Bankruptcy Law governs those organisations other than enterprise legal persons that fall within the category of bankruptcy liquidation (Article 135).

#### *Establishment of the Rule of Administrator*

The new concept of administrator was established in the New Bankruptcy Law, which provides that the People's Court is required to appoint an administrator upon acceptance of a bankruptcy petition. Personnel from relevant departments and agencies and an intermediary organisation established in accordance with the law, such as a law firm, accounting firm or bankruptcy liquidation firm, can act as administrator (Article 24). The administrator's main duty is to take over the management of the debtor's property and assets and some other relevant affairs, such as participating in actions, arbitrations or any other legal procedure on behalf of the debtor; proposing to hold creditor's meetings; and performing any other functions and duties that the People's Court believes it should perform (Article 25). At the same time, the administrator must carry out its duties and report to the People's Court, and is subject to monitoring and supervision by the creditors (Article 23). The creditors may petition the People's Court to replace an administrator if they think the administrator is unable to carry out its duties in a lawful or impartial manner, or if there are circumstances that would prevent the administrator from carrying out its duties competently (Article 22). An administrator can also resign, but only for good reason, and must obtain prior approval from the People's Court (Article 29).

#### *Emphasis of Creditor's Autonomy*

Compared with the 1986 Bankruptcy Law, two changes were made to the functions and duties of a creditor's meeting. First, under the 1986 Bankruptcy Law, the creditor's meeting had the power to review and verify the creditor's claim (Article 29). However, the New Bankruptcy Law empowers the administrator to review the creditor's claim (Article 61) and the creditor's meeting to verify the creditor's claim (Articles 58 and 61). Secondly, the function and duties of the creditor's meeting were significantly widened, and now include supervising the administrator, selecting and altering the members of the creditor's meeting, deciding to continue or stop the debtor's business operations, deciding whether to adopt restructuring plans or settlement agreements, etc. (Article 58).

In addition, the New Bankruptcy Law provides for the establishment of a creditor's committee. The creditor's committee shall be appointed by the creditor's meeting and shall consist of no more than nine members. The members are required to be approved by the People's Court. Furthermore, the creditor's committee must include a representative of the workers' union of the debtor (Article 67). While the creditor's committee performs its function and duties, it has the power to require the administrator and debtor to give an explanation on any matter within the scope of its functions and duties or to provide relevant documents (Article 68).

Without doubt, these provisions provide vital protection for a creditor's benefit. In fact, the creditor's autonomy also plays an important role in the restructuring procedure. The creditors can directly apply to the People's Court for restructuring of the debtor by the law (Article 70), and the creditor's meeting can vote for a restructuring plan (Article 61), which is of decisive significance to the procedure.

#### *Establishment of Restructuring Plan*

As a method for rebuilding the debtor's repayment procedure, the international predisposition is to establish restructuring rules for the purpose of reviving the debtor. In order to avoid the unemployment or loss of social wealth caused by bankruptcy liquidation, the New Bankruptcy Law establishes restructuring rules to help those enterprises that still could come back to life.

An application may be made on the basis that the debtor is insolvent and its assets are insufficient to discharge all of its debts, or that it clearly lacks (or there is a marked likelihood that it lacks) capacity to discharge them (Article 2). When a creditor has already petitioned for the bankruptcy of a debtor, the debtor or a shareholder holding one-tenth or more of the registered capital may also file an application to restructure the debtor (Article 17). While the New Bankruptcy Law places the responsibility for preparing the restructuring plan on either the debtor or administrator (Article 71), the debtor is responsible for the implementation of the plan once it has been approved by the People's Court (Article 89). The restructuring period lasts from the day that the People's Court approves the restructuring until the termination of the proceedings (Article 72).

#### *Regulation of Fraudulent Transactions*

Fraud in bankruptcy strikes globally. This phenomenon is especially serious in China. Some debtors try to damage a creditor's as well as the employees' interest by using various fraudulent transactions during the procedure of bankruptcy. Some of them have even been supported by local governments. Hence, the New Bankruptcy Law provides much more tailored provisions to revoke or undo certain transactions involving property of the debtor that occurred within a limited period. It provides that administrators, upon petitioning the People's Court, have the power to undo certain transactions involving property of the debtor conducted within one year before the People's Court accepts the bankruptcy petition. These transactions include gifts, transfers at an undervalue, securities given for unsecured debts, early repayment of debts that have not fallen due and abandonment of rights to repayment (Article 31). Certain other activities involving the debtor's property are simply void; these include the concealing or transferring of property to avoid debts, and fabrication of debts or acknowledgment of debts that are not genuine (Article 33). The New Bankruptcy Law empowers administrators to recover property obtained as a result of such transactions (Article 34).

#### *Strengthening of Bankruptcy Liability*

The 1986 Bankruptcy Law does not impose any liability on managerial members when an enterprise goes to bankruptcy. The New Bankruptcy Law, however, does provide relevant provisions that work in combination with the newly amended Company Law, Securities Law and Criminal Law to impose liability on managerial members. It provides that those managerial members—including directors, supervisors and senior managers—who commit a breach of their obligation of loyalty or due diligence, causing the enterprise to go bankruptcy, shall bear civil liability. Furthermore, they will also be prohibited from acting as a director, supervisor or senior manager of any enterprise for three years from the day of the conclusion of bankruptcy procedure (Article 125). Under the detailed provisions of civil liability, administrative liability and even criminal liability, the liability of directors, supervisors and senior managers is greatly strengthened.

#### *Priority of Secured Creditors*

According to the 1986 Bankruptcy Law, employee claims were paid first, before those of the creditors. After the promulgation of the New Bankruptcy Law, secured creditors in relation to their secured assets shall be paid first, and employee claims and other welfare shall be paid from unsecured assets (Article 109). However, the New Bankruptcy Law provides that as a kind of extension, employee claims that were incurred prior to the promulgation of the New Bankruptcy Law are to be paid from the secured assets in priority to secured creditors' claims if they can not be satisfied out of the debtor's unsecured assets (Article 113 and 132).

### *Cross-Border Bankruptcy*

As a result of the globalisation of capital movement, a bankruptcy judgment in one country can have a huge impact on creditors or debtors in another country. Many transnational bankruptcies that have connections to many overseas debtors have occurred in China. Taking this into consideration, the New Bankruptcy Law provides that bankruptcy proceedings initiated under the New Bankruptcy Law are to be binding on the debtor's property and assets worldwide (Article 5, paragraph 1). Also, the People's Court may adjudicate, recognise and enforce legally valid, foreign bankruptcy court judgments and rulings involving a debtor's property and assets located within the People's Republic of China. However, the prerequisite is that a treaty or principles of reciprocity in bankruptcy proceedings (or judgments in them) exist and that the petition does not contravene basic principles of Chinese law; prejudice the sovereignty, security and public and social interest of the country; or hurt the legitimate rights and interests of creditors in China (Article 5, paragraph 2).

### *Closing Comments*

Although there have been many comments that the New Bankruptcy Law is not adequate to address all the issues raised in bankruptcy (for example, see the article published by the Deputy Judge of the Supreme People's Court on 12 June 2008 in the *People's Court Daily*, available at <http://rmfyb.chinacourt.org/public/detail.php?id=119905>) and that the effectiveness of the New Bankruptcy Law remains uncertain, especially from the enforcement level, the New Bankruptcy Law will certainly play a fundamental part in perfecting the legal system of a socialist market economy. In addition, with the establishment of many new regulations, such as restructuring plans, strengthening of managerial members' liability, priority of secured creditors, establishment of the administrator and enforcement of cross-boarder bankruptcy judgment, the New Bankruptcy Law provides a strong legal protection for economic stability and optimisation of economic structure, improves the social economic honesty system and meets the challenge of economic globalisation.

While the Supreme People's Court has issued some judicial interpretations and will issue more detailed regulations to better enforce the New Bankruptcy Law, after more than one year's enforcement of the New Bankruptcy Law, some attempt has been made to analyse the relevant issues by the local courts (see <http://bjgy.chinacourt.org/public/detail.php?id=64035>) and the Supreme People's Court (see <http://rmfyb.chinacourt.org/public/detail.php?id=119905>). With the forthcoming and more detailed enforcement measurements, it is expected that the New Bankruptcy Law will play an increasingly important role in furthering China's market economic reforms.

## **Measures for Registration of Pledges for Equity Interest**

On 1 September 2008, to implement the registration of pledges for equity interest, the State Administration for Industry and Commerce (SAIC) released the Measure for Registration of Pledge for Equity Interest (Measure), which will come into force on 1 October 2008.

### **Background**

To pledge equity interest, one must sign a pledge contract and register the pledge for equity interest. The former step is to indicate the rights and obligations of the pledgee and pledgor. The latter is necessary to show the pledgee's preemptive right of compensation, as third parties otherwise cannot ascertain if the shares have been pledged. The Property Law dated 1 October 2007 provided for registering a pledge of unlisted shares of a joint stock limited company or a limited liability company. This law rectifies the requirement for pledge of shares by requiring registration of the pledge at the Administration for Industry and Commerce Department. This is in line with the existing requirement to register a pledge of equity interest in a foreign investment enterprise issued by SAIC on 24 August 2006.

However, given the fact that before the Measure there was no relevant regulation for implementation, local branches of the Administration for Industry and Commerce declined to receive applications for pledge registration. Thus, in order to start the pledge registration of share equity, which can provide capital to the company through equity interest pledges, several local governments issued their own regulations. For instance, the authority of Zhejiang Province promulgated its own measure several months ago. In practice, this registration is limited to pledge equity rights to bank. Moreover, since the procedure regarding registration of pledges for equity interest was stipulated according to local situations, the details of those measures are actually inconsistent.

Therefore, given the importance of standardizing existing regulations and formulating rules on registration of pledges for equity interest that can be adopted throughout China, the Measure was stipulated for the purpose of regulating the registration of pledges protecting the legitimate rights and interests of pledge parties and interested parties.

## Scope for Application

According to the Property Law and the Measure, the provisions under the Measure shall govern the following:

- Limited liability companies
- Joint stock limited companies

However, this Measure does not apply to listing shares or fund units. As for the pledge of fund units and stock rights registered in the securities depository and clearing institution, the right of pledge shall be established after the Administration for Industry and Commerce has registered the pledge.

## Authorized Body Conducting Registration

The Administration for Industry and Commerce is the registration authority for pledges.

In the past, foreign investment enterprises were required to submit applications to the Administration for Industry and Commerce according to requirements to register a pledge of equity interest in a foreign investment enterprise. As of October 2008, the registration must be carried out by the Administration for Industry and Commerce for both foreign companies and domestic companies.

In particular, Article 14 of the Measure stipulates that the registration authority shall register and issue the notification immediately, which means an applicant does not need to wait for several days to obtain the notification of registration, as is the case in other relevant procedures.

## Parties Involving the Registration

Article 7,9,11 of the Measure provides for the materials for registration, or to change or cancel registration. The following parties are involved in the process of registering pledges for equity rights:

- The pledgor, the owner of the equity.
- The pledgee, the creditor of the debtor enjoying priority rights to get satisfaction from the value of the pledged equity (both natural persons and legal entities can act as pledgees)

Thus, the application shall be submitted by both parties.

## Shares Can Be Transferred and Pledged

The Measure clearly stipulates that the condition for registering a pledge for equity rights must comply with Article 5, which provides that equity rights shall be legally transferred and pledged. Thus, for stocks frozen by the court, applications for pledge registration cannot be submitted until such frozen stocks have been released. For the stocks of foreign-funded enterprises, the enterprise must obtain the approval from the examination and approval departments firstly.

Further, the restrictions and restraints of shares transfer stipulated by the Company Law, the Guarantee Law and other regulations include but are not limited to the following:

- Special limitations: if the transfer of equity right is provided for in the article of associate, the article of associate shall be followed.
- Time limitations: the shares of a company held by the promoters of such company shall not be transferred within one year after the date of the establishment of the company.
- Limitation on number of shares: the directors, supervisors and senior managers of the company shall declare to the company the shares they hold and any changes thereof. During the term of office, the shares transferred by any of those parties each year shall not exceed 25 per cent of the total shares of the company that individual holds.
- Additional limitation on foreign investment companies: A foreign investment company must obtain consent from other investors in the enterprise and approval from the examination and approval departments, and must not pledge the equities to be created with the part of investment it has not yet paid. Neither shall the investor pledge its equities to the same enterprise in which it has invested.