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Current Trends in China's Bankruptcy Filings

This update outlines the current trends in China's bankruptcy filings based on surveys and data of bankruptcy court cases released by the Supreme People's Court (SPC) in the past five years.

Historically, China's economy has evolved from a planned economy to a market-oriented system. When China launched a series of economic reforms in 1986, the government passed its first bankruptcy law, which applied only to state-owned enterprises (SOEs). The purpose of the 1986 law is to allow unprofitable SOEs nationwide—mainly SOEs formed by local governments as opposed to national-level SOEs—to liquidate.

Subsequently, private companies incorporated as legal persons were included into the bankruptcy system with the enactment of the 1991 PRC Civil Procedural Law.

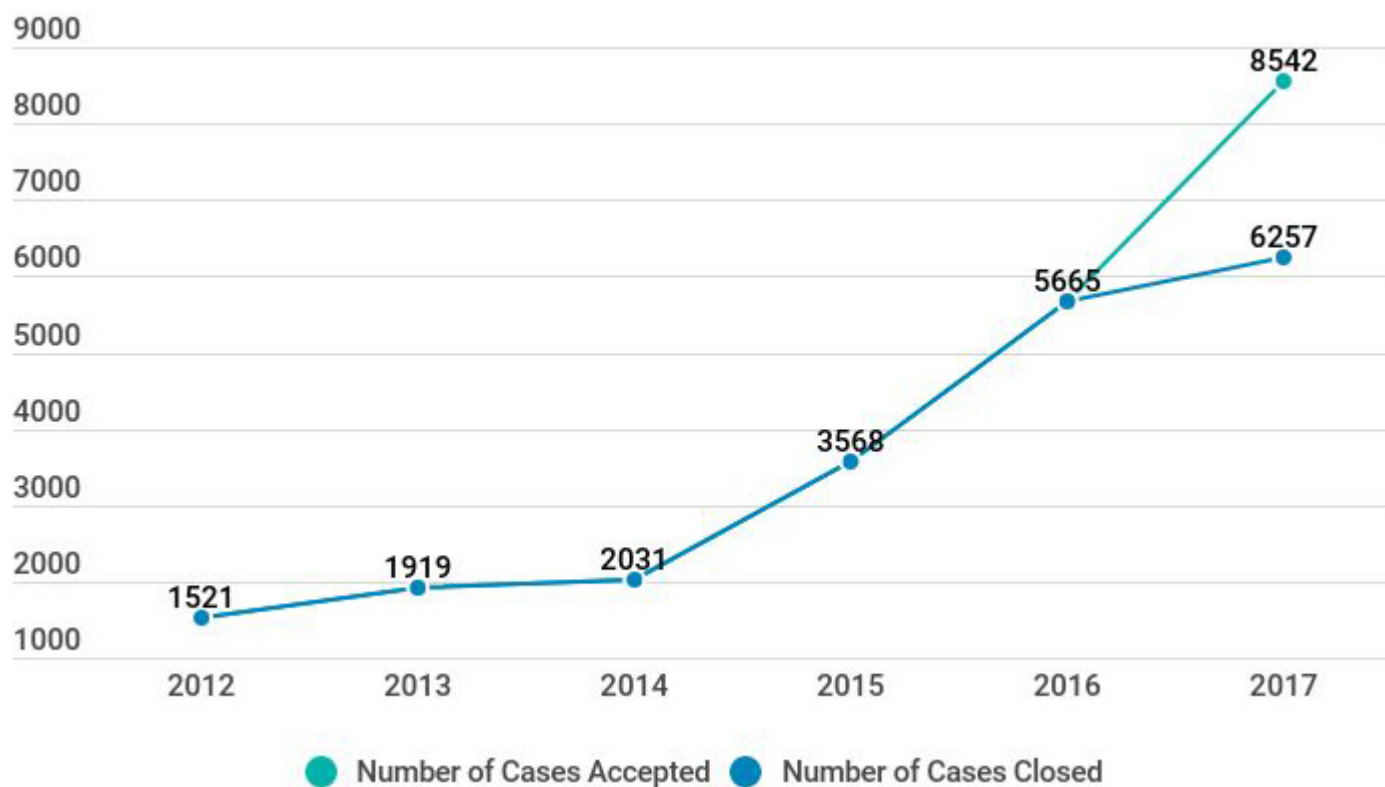
China completely amended its bankruptcy law in 2007, which introduced the option of reorganization, as opposed to only liquidation. The new law was adopted with the support of foreign bankruptcy specialists and generally modeled after Western legal principles. Since its promulgation in 2007, bankruptcy cases steadily increased. SOE bankruptcy filings have focused on heavy industries, such as steel and coal production, as opposed to high-tech firms or firms in pillar industry sectors.[1]

In addition to the development of the law, by the end of 2017, 97 courts throughout China had established liquidation and bankruptcy divisions to facilitate the trial and settlement of bankruptcy cases. In early 2015, only five courts in China had such tribunals.[2]

The current available data released by the SPC in 2018 indicates an increase in bankruptcy court filings of 68.4% compared with the previous year.[3]

Further, per the bankruptcy cases published on the National Enterprise Bankruptcy Information Disclosure Platform, of the total number of ongoing bankruptcy cases filed nationwide only 289 cases, or **10.5%**, were filed by SOEs—and most of these are smaller, regional SOEs.

Bankruptcy Cases Accepted and Closed between 2012 and 2017



Although the central government has issued supporting policies to encourage bankruptcy filings (and has trained judges and lawyers on bankruptcy principles), SOE executives are still confronted by a host of laws, regulations and Communist Party rules that punish poor financial performance and thus work to discourage managers and shareholders from seeking bankruptcy court relief and protection. It is not just the cultural stigma of bankruptcy, but the fact that the law places a significant burden on SOE managers to financially perform or risk investigation and punishment.[4] The filing of bankruptcy in China can be a career-ending event for executives and board members and might also lead to Party disciplinary investigations (via the Central Commission on Disciplinary Inspection).

10 Guiding Cases on Bankruptcy

Even though the development of China's bankruptcy law practice is still in an early stage, the SPC and the courts at lower levels have spent huge efforts trying to grow their experience in the bankruptcy field. One such effort was the release of the details involved in 10 typical bankruptcy cases on March 6, 2018. These cases are meant to guide bankruptcy judges across the country on their judgments. The majority of these cases are bankruptcy reorganization filings, as opposed to bankruptcy liquidation filings, and half of the debtors are private firms while the other half are SOEs. The facts in these 10 cases also reflect substantial involvement of local governments that bring in strategic buyers to finance the debtors, help settle employee claims, etc. to maintain stability in the local jurisdictions.

The below summary of the cases provides the SPC's comments, which outline the court's guidance to lower courts when dealing with similar bankruptcy cases. Overall, these cases are a reflection that there is a significant learning curve with respect to bankruptcy cases in Chinese court.

Bankruptcy Liquidation Filed by Zhejiang Nanfang Petrochemical Industry Co., Ltd., et al. (Private Firm)

The SPC comments that this case is a good example of how the bankruptcy court, in a liquidation proceeding, can help the debtor enterprise maintain its productivity, save employees' jobs, achieve regional industrial integration and upgrade with supportive industrial policies from the local government.

2. Transfer of Enforcement Action for Bankruptcy Review filed by Songhui Industry (Shenzhen) Co., Ltd. (Private Firm)

The SPC comments that this case is typical as it provides guidance on handling competing employee claims against the employer in civil enforcement actions. In particular, the court had a hard time balancing the employees' interests in the enforcement actions filed by the 459 unpaid employees; thus, transferring the enforcement actions for bankruptcy review was an efficient way to ensure the employees were fairly paid and to further avoid employee protest.

3. Bankruptcy Reorganization Filed by Chongqing Iron and Steel Co., Ltd. (SOE)

The SPC comments that this case has significant value in that it is the first restructuring case in the country related to a dual-listed SOE (both A Stock-listed and H Stock-listed) in the steel and iron industry. The local court used the bankruptcy reorganization mechanism to spin off bad assets of the company and introduced industrial structure adjustment funds through the capital market channel.

4. Bankruptcy Reorganization Filed by Jiangsu Textile Industry (Group) Import and Export Co., Ltd., et al. (SOE)

The SPC comments that this case shows the local court's exploration of joint review of bankruptcy reorganization cases filed by six affiliated SOEs. Specifically, the local court consolidated six bankruptcy reorganization proceedings into one, given that the debtors share similar assets and debts as well as resources, to ensure a successful reorganization. This case highlights the bankruptcy court's function in providing social value and offering helpful assistance to the ongoing SOE reform.

5. Bankruptcy Reorganization Filed by Yunnan Coal Chemical Industry Group Co., Ltd., et al. (SOE)

The SPC comments that in the context of cutting excessive industrial capacity and making structural adjustments, this is a typical case where the local court, through the bankruptcy reorganization proceeding, shut down 18 unprofitable coal mines within the debtor's group, reduced excessive coal capacity in the amount of 3.57 million tons per year and settled employment claims with 14,552 laid-off workers.

6. Bankruptcy Reorganization Filed by Beijing Technology Zhongxing Science and Technology Co., Ltd. (SOE)

The SPC comments that this is the first bankruptcy reorganization case filed by a non-listed public company on the National Equities Exchange and Quotations. The local court, through the bankruptcy reorganization proceeding, helped the debtor introduce investments and financings. The local court creatively took the pre-reorganization method through holding hearings to discuss reorganization plans among creditors and investors.

7. Bankruptcy Reorganization Filed by Zhuangji Group Co., Ltd. (Private Firm)

The SPC comments that this case shows how the local court can exercise its mandatory right of approval on a draft reorganization plan when the creditor's group cannot reach a consensus. Even though the court proceeding ended after the local court issued its order of approval, the local court took further steps to help the debtor restore its credit to enjoy tax benefits. After the successful bankruptcy reorganization, the debtor became the top tax payer in the local city.

8. Bankruptcy Reorganization Filed by Fujian Anxi Tieganyin Group Co., Ltd. and Affiliates (SOE)

The SPC comments that this is a typical case showing how the bankruptcy reorganization proceeding promoted a traditional agricultural enterprise to upgrade its production. In particular, the Chinese traditional tea brand "Anxi Tieganyin" survived and the investors brought in an internet-based business model.

9. Bankruptcy Reorganization Filed by Zhongshun Automobile Holding Co., Ltd. (Private Firm)

The SPC comments that the significance of this case is that it shows how the local court can make sound

business judgments in carefully selecting competent investors suiting the debtor's business model in the automobile industry. The local court worked efficiently to assist relevant government agencies in issuing licenses for the debtor and helped achieve the goal of revitalizing an old industrial base in northeast China.

10. **Bankruptcy Reorganization Filed by Guilin Guangwei Wenhua Tourism Culture Industry Co., Ltd. (Private Firm)**

The SPC comments that this is the first bankruptcy reorganization case accepted by the higher people's court. Given the significance of the debtor running the world's largest natural theater, "Impression Sanjie Liu," the Guangxi Higher People's Court allowed the debtor to independently run the theater without interference by the court proceedings and was able to help the debtor turn losses into profits and boost the local tourism industry.

Endnotes

[1] "Pillar industry" is a term commonly used in Chinese articles meaning an industry important to the economy, such as manufacturing.

[2] In early 2019, three major cities in China set up separate bankruptcy courts: Shenzhen in the Guangdong Province set up its bankruptcy court on January 14, 2019; Beijing set up its bankruptcy court on January 30, 2019; and Shanghai set up its bankruptcy court on February 1, 2019. The establishment of the three bankruptcy courts is considered a solution to support the enforcement of civil judgments where the plaintiffs face difficulty in receiving payment from judgment debtors. In cases where judgment debtors are unable to satisfy the judgments, the enforcement action may be transferred to an involuntary bankruptcy proceeding at the bankruptcy court to finally close the civil case, which usually goes through case acceptance, trial and enforcement proceedings. In addition, bankruptcy courts are equipped with better-trained judges, more independent trustees are named as bankruptcy administrators, and the secured and unsecured creditors can achieve higher coordination through simplified procedures for creditors to vote.

[3] According to the SPC, in March 2018, the number of bankruptcy filings accepted was 1,521 in 2012; 1,919 in 2013; 2,031 in 2014; 3,568 in 2015; 5,665 in 2016; and 9,542 in 2017, with an average growth rate of 47%. The number of cases closed also experienced an increasing trend: 1,521 in 2012; 1,919 in 2013; 2,031 in 2014; 3,568 in 2015; 5,665 in 2016; and 6,257 in 2017, at an average growth rate of 28%.

[4] Article 122 of the Regulations on Disciplinary Measures of the Communist Party of China (2003 version), provides: "[T]hose who violate the regulations on the management of state-owned assets and cause the loss of state-owned assets shall be given warning or serious warning and punishment to the main responsible persons and other persons directly responsible; if the circumstances are serious, they shall be given a punishment of revoking their positions within the Party or leaving for inspection; if the circumstances are more serious, they shall be given a punishment of dismissal from the Party membership." In addition, Article 32 of the Measures for Implementing Investigation of Investment Responsibility of Central Enterprises for Violating Regulations provides: "After verification and responsibility confirmation, the central enterprise shall, in addition to transferring the assets to the disciplinary inspection and supervision organs or judicial organs for disposal in accordance with relevant provisions, deal with them in the following ways: (1) Where losses of general assets occur, the person directly responsible and the person in charge shall be given critical education, ordered to inspect in writing, notified of criticism, admonished and encouraged, and the annual salary for performance under 50% of the year for which the liability is determined may be deducted and recovered; (2) Where there is a large loss of assets, the person directly responsible and the person in charge shall be given such treatment as notification, criticism, admonition, suspension, removal of his post and demotion. At the same time, the compensation of executives may be reduced for poor financial performance such as under the following criteria: annual performance salary of 50-100% in the year of deduction and recovery of liability, annual term incentive income of 50-100% in the year of determination of liability (including the first three years) and annual

performance salary shall be deferred, and the payment of annual performance salary shall be terminated. Other medium and long-term incentive rights and interests that have not been exercised, all medium and long-term incentive gains of the year in which the responsibility for surrender has been ascertained and the previous year, and new medium and long-term incentives of enterprises shall not be taken part in within five years; Leaders should be notified and criticized, warned and encouraged, suspended or removed from their positions, and their remuneration should be deducted according to the following criteria: 30% to 70% annual performance salary in the year of deduction and recovery of responsibility, 30% to 70% term incentive income in the first three years (including) of the year of determination of deduction and recovery of responsibility, and deferred payment of annual performance salary; other long-term and medium-term incentive rights and interests that have not yet been exercised should not be terminated within three years. Participate in new medium and long-term incentives for enterprises; (3) Where significant asset losses occur, the person directly responsible and the person in charge shall be demoted, transferred to a non-leading position, ordered to resign, removed from office and prohibited entry restrictions. At the same time, the remuneration shall be deducted according to the following criteria: the annual performance salary of 100% in the year of deduction and recovery of liability determination, the term incentive income of 100% in the year of deduction and recovery of liability determination (including the first three years) and the annual performance salary shall be deferred and terminated. Other long-term and medium-term incentive rights and interests that have not yet been exercised, and all long-term and medium-term incentive gains in the first three years of the year (including the first three years of the determination of surrender responsibility) shall not be allowed to participate in the new long-term and medium-term incentives of enterprises; Relocation, demotion, transfer to non-leading positions, order resignation, dismissal and prohibition of entry shall be given to those responsible for leadership. At the same time, compensation shall be deducted according to the following criteria: annual performance salary of 70%-100% in the year of deduction and recourse responsibility determination, annual term incentive income of 70%-100% in the year before (including) three years, and annual performance salary shall be deferred, and those that have not yet been exercised shall be terminated. He is not allowed to participate in the new medium and long term incentives for enterprises within five years."

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