COVID-19 – top China court puts restructuring to the fore in key corporate insolvency rulings

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China's top court has recently been getting to grips with key issues relating to restructuring and insolvency of some of its most vital industries. In eight separate decisions, the Supreme People's Court has shown its determination to support businesses and to help kick-start the domestic economy and the global supply chain.

Whilst these particular decisions relate to domestic China companies, the trend will also be of interest and relevance to multinationals with business in China who will be concerned as to the impact of the prolonged economic shock brought about by COVID-19.

Every year the Supreme People's Court (SPC) issues case examples primarily for the purposes of informing and educating the legal community and providing guidance to lower courts, although cases do not carry precedential value in China. The focus this year is on cases associated with COVID-19, and in particular how the bankruptcy laws can be used to achieve positive outcomes. These illustrations are instructive and the cases carry with them important lessons for enterprises doing business in China. Here's what you need to know.

Amongst the eight judgments issued by the SPC on 31 March 2020 (please click here for the English summary), one involved an attempted settlement between creditors and debtors, five were concerned with company restructuring and two involved the liquidation process itself. Many of the companies involved produce urgently needed medical and personal protective equipment currently in demand in China and around the world.

Back on track – court orders renegotiation of debt composition agreement

Guangdong Xingangxing Concrete Co., Ltd is a company engaged in concrete processing. Because of a high cost capital loan that it had been bearing for many years, it found itself unable to pay its creditors which led to litigation. Some of the company's bank accounts, assets and mechanical equipment had been seized, and its operations were frozen.

On 19 March 2019 it entered formal liquidation and was then transferred into the bankruptcy settlement process. A draft debt composition agreement was given legal effect in January 2020.

The COVID-19 outbreak led to the company facing further difficulties in paying off the liabilities set out in the agreement.

The court stepped in to order a renegotiation of the agreement and reschedule the debts due under it. Through the bankruptcy settlement, the company managed to restructure the debt of Chinese yuan (CN￥) 170 million, maintained the company's production capacity and eventually resumed work and production on 27 February 2020.

This case shows the court utilizing the bankruptcy protection mechanism available under the law in order to comprehensively restructure the company's liabilities which had threatened its future survival.

The court made full use of the so-called "transfer of enforcement cases for bankruptcy review" mechanism to actively guide the enterprise through the bankruptcy process. Once the application for bankruptcy had been accepted, the court converted the procedure into a one-off settlement, thereby avoiding liquidation.

Transformation

Another company manufacturing medical devices, Sichuan Southwest Medical Equipment Co., also applied for the "transfer of enforcement cases for bankruptcy review" procedure. The court in Chengu mandated bankruptcy protection in September 2019.

After the outbreak of the epidemic, a company outside the province itself hoped to use the company's cleanroom workshop to produce protective masks and continue production of X-Ray machines.

The court performed a comprehensive evaluation of the situation, including the company's ability to attract potential investors. The court approved the application on the day of application.

Since the resumption of production, the company has produced more than 2.3 million protective masks and is fulfilling orders for nearly CN￥one million in medical X-Ray machines.

This is a case of the court making full use of its inherent discretion, abandoning the original proposal that the company should end up in liquidation. The court's ruling also helped to protect the interests of creditors and safeguard the value of the enterprise for possible further investment.

Company restructuring front and center

In five other cases, including one involving Jiangsu Panyu Technology Co., Ltd, a medical device manufacturer, and the companies in question all encountered obstacles during the implementation of a reorganization plan.

The court refrained from ordering liquidation directly and instead, the courts communicated with relevant government departments to restore their credit rating and assist with measures enabling the resumption of work, while the reorganization continued.

In doing so, the court helped the enterprises in question stay open, manufacturing much needed face masks and pharmaceutical supplies.

Liquidation

During the liquidation of Yinjing Medical Technology (Shanghai) Limited, the impact of COVID-19 provoked a global shortage in medical materials such as surgical masks. The court helped the administrator to auction the masks in the company's stock and to seek third-party funding to resume the production of medical supplies, thereby allowing the enterprise to resume work and production.

Takeaway

The SPC believes these cases reflect the courts' determination to make full use of the bankruptcy protection mechanisms they have available, prioritizing the rescue of enterprises, and safeguarding livelihoods.

Bankruptcy cases in China often involve layoffs and questions of social stability. The cases emphasize the need for courts to be proactive and step in where an enterprise can be rescued.

As the SPC stated in "The Minutes of the National Court Work Conference on Bankruptcy Trials" issued in 2018, "...the four working mechanisms of bankruptcy trials include the identification of enterprises going bankrupt and which need to be reorganized, coordination between the government and the courts, the exchange of information on cases, and the lawful and orderly balancing of interests."

Simply applying the law would be likely to result in excessive losses, low recovery for creditors, debtor enterprises being made bankrupt and employees losing their jobs. In these cases (which all involved domestic enterprises), the courts have played an active role in helping to coordinate government efforts, restructuring the enterprises where possible and thereby saving the enterprises concerned and protecting the interests of creditors, a win-win result.

COVID-19 has had a major impact on many operations in China, threatening their future solvency. When considering options, the SPC wants companies and the legal profession to bear in mind the judicial thinking of the Chinese courts as outlined in these cases. This appears to be a step forward in embracing the options for restructuring under the Enterprise Bankruptcy Law and perhaps seeking to remove some of the stigma which has traditionally been associated with bankruptcy in China.

Further information about restructuring and insolvency procedures in China can be found in our new *Cross Border Guide to Restructuring and Insolvency*.

The guide considers important 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 guide also includes helpful flowcharts on the procedures for bankruptcy petitions, liquidations, reorganizations, and compromise agreements.

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Through our association with Hogan Lovells Fidelity, a joint venture between Hogan Lovells and Fujian Fidelity Law Firm, we are well-placed to help clients navigate their way through the legal framework and practical application of China's insolvency regime

Hogan Lovells can help you respond to any challenges impacting you, across your business, anywhere in the world. We have a set of tools available through our dedicated COVID-19 Topic Centre discussing issues such as *force majeure*, supply chain disruption, employment, contract clauses, data protection, insurance, and crisis leadership.

To know more, get in touch with us at COVID19@hoganlovells.com or speak to your usual Hogan Lovells contact.

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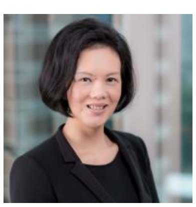

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