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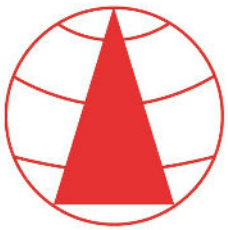
The Implications of Brexit for the Restructuring and Insolvency Industry

A Collection of Essays



INSOL International™

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East Asia and the Pacific Rim

China (PRC)*

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INTRODUCTION[4]

Having initiated its withdrawal from the European Union under Article 50 of the Treaty on European Union in March 2017, the UK is expected to formally leave the European Union in March 2019.

This essay will consider the impact of Brexit on cross-border insolvency recognition between the UK and the People's Republic of China ("PRC" or "China"). This impact has significant relevance given that the PRC and the UK are respectively the second largest and the fifth largest economies in the world.

HISTORY AND DEVELOPMENT OF PRC BANKRUPTCY LAW JURISPRUDENCE[5]

In order to understand the PRC Bankruptcy Law framework and system, it is first necessary to obtain some perspective on the history and development of Chinese bankruptcy law jurisprudence.

Traditional Chinese Jurisprudence

Historically, the Chinese legal system never formally recognised the concept of bankruptcy. It was noted that the Chinese tradition was that "debts incurred by the father shall be assumed by the son".[6] Hence, traditionally enshrined in Chinese culture (even though not necessarily protected by a formal legal framework), creditors rights were unquestionable and debts were never forgiven - debts were passed down to the next generation.

The first attempt at introducing the concept of bankruptcy law (with the concept of debt resolution) in China, was in 1906 during the late Qing Dynasty. However, this effort was annulled in 1908 by Emperor Guang Xu due to difficulties of implementation. In 1935, the Nationalist Government published a bankruptcy law that is still in force in Taiwan today.[7]

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* The views expressed in this essay are the personal views of the authors, which are not to be taken as representing the views of INSOL International or any of its affiliates or representatives.

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4 We have endeavoured to state the law as at 25 August 2017.

5 It is acknowledged that this section is cited from an article first published by the first author in: K. Ong and M. Hsiao, "From ISDA to NAFMII: Insolvency stalemate and PRC bankruptcy jurisprudence", (2013) *Capital Markets Law Journal* 77.

6 S. Li, "Bankruptcy Law in China: Lessons of the Past Twelve Years", (2001) 5(1) *Harvard Asia Quarterly* (23 Feb 2006) [Li].

7 *Ibid.*

Influence of Marxism

When the Communist Party established the PRC in 1949, all laws enacted by the Nationalist Government were abolished. Many former privately-owned enterprises were turned into State-owned enterprises.[8] State-owned enterprises became the backbone of the economy, providing goods, services, employment and other benefits. State-owned enterprises were supported by the State and did not have to bear their losses (or profits) independently, so bankruptcy was never an issue.

As State-owned enterprises were not profitable entities in their own right, the State was required to support them financially. In practical terms, State-owned enterprises proved to be economic disasters.[9] It came to a stage where certain State-owned enterprises that found themselves in serious financial difficulties, could no longer continue to operate. However, the PRC Government feared that strict application of bankruptcy laws to insolvent State-owned enterprises would create two serious problems: (a) high unemployment, which could result in social unrest; and (b) a knock-on effect on the banking sector leading to the bankruptcy of many State-owned banks.[10] Amazingly, these factors are strikingly similar to the reasons provided by Western governments to justify the bailing-out of Western banks following the 2008 financial crisis.

Given these overriding fears, unsustainable State-owned enterprises had to be closed, suspended or consolidated, the business model would be changed by administrative orders, or they went bankrupt automatically without going through any legal procedure. The facts surrounding bankruptcies were also kept secret. In such cases, bankruptcy or insolvency would occur without any legal recourse and nothing would be due or owing to creditors.[11] Hence, following the communist revolution, there was a complete shift in policy and attitude away from creditors' rights. From traditionally having supreme and unquestionable rights, creditors suddenly found themselves having practically no rights in a bankruptcy.

1986 PRC Enterprise Bankruptcy Law

In the early 1980s, shortly following the inauguration of PRC's "open door policy", the PRC government realised the drawbacks of the Marxist planned economy model in dealing with insolvent enterprises. This resulted in the enactment of PRC's 1986 Enterprise Bankruptcy Law in December 1986 ("1986 EBL"), which dealt with bankruptcies of State-owned enterprises. This was the first significant attempt at bankruptcy reform under the Chinese Communist Party, and was significant in that it provided a legitimate method for the bankruptcy of State-owned enterprises (which previously could not enter proper bankruptcy).

In April 1991, the National People's Congress issued an amendment to the Code of Civil Procedure that provided a direct basis for handling bankruptcies of non-State-owned enterprises. The Code provided that repayment procedures specified in the 1986 EBL were applicable to all legal entities. This resulted in a major increase in company insolvency cases involving both State-owned and non-State-owned enterprises.[12]

Notwithstanding these developments, creditors still faced great difficulty in recovering their debts from bankrupt Chinese companies. Consistent with Marxist ideology on protecting

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[8] This was in line with the Marxist theory that the production of capital belonged to the people of China. See K. Ong & C. Baxter, "A Comparative Study of Fundamental Elements of Chinese and English Company Law" (1999) 48(1) *ICLQ* 88, at fn. 18. [Ong & Baxter].
[9] *Ibid.*, at p. 91.
[10] C Booth "The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over", (2008) 20 *SAcLJ* 275, p. 285 [Booth].
[11] S. Li, *supra* note 6, at fn. 19.
[12] *Ibid.* Reportedly, over 16,000 cases between 1988 to 2006.

workers' rights,[13] money recovered from bankrupt companies must be used to settle employees first. In addition, bank creditors have priority over non-bank creditors for the remaining money (if any).[14] There is often little or no money left after settling employee creditors, such that even bank creditors generally oppose bankruptcy filings. The bankruptcy process is made even more challenging by concerns about "identity" and "instability" and the need to resettle employees into new jobs – this is because, fundamental to communist ideology, State employees (or government servants) were guaranteed an "iron rice bowl" or life-time employment.[15] These challenges meant that for non-bank creditors, it was simply commercially not worth initiating or pursuing bankruptcy. Commentators have noted that "legal mechanisms to guarantee creditor's interests are weak at best",[16] and the 1986 EBL was no more than a "paper tiger".[17]

2006 PRC Enterprise Bankruptcy Law

The PRC insolvency law received a major overhaul following the introduction of the 2006 PRC Enterprise Bankruptcy Law ("2006 EBL"). The 2006 EBL, which became effective on 1 June 2007, introduced a uniform bankruptcy law for all legal persons in PRC. The 2006 EBL imported concepts drawn from international market bankruptcy standards for restructuring, reorganisation and conciliation.

Of particular interest is the strong protection afforded to creditors. For example, the 2006 EBL entitles creditors to enforce a foreign bankruptcy decision against a debtor's assets inside China in accordance with bilateral or multilateral treaties or the principle of reciprocity.

Although there remain some concerns about its proper function in practice,[18] the 2006 EBL nevertheless has improved creditors' standing in bankruptcy cases.

RECOGNITION OF CROSS-BORDER INSOLVENCY PROCEEDINGS IN THE PRC

For the first time in China's bankruptcy jurisprudence, the 2006 EBL formally provided for the recognition and enforcement of foreign insolvency proceedings in China.

Article 5 of the 2006 EBL provides as follows:

> "Bankruptcy proceedings initiated according to this Law shall be effective with respect to the debtor's property located outside the territory of the People's Republic of China.
>
> With regard to a legally effective ruling or decision on a bankruptcy case made by a foreign country, if such ruling or decision involves the property of the debtor within the territory of the People's Republic of China, and an application or a petition for the recognition and execution thereof is filed with the People's Court, the People's Court shall, according to *international treaties* concluded or participated by the People's Republic of China or the principle of *reciprocity*, review the ruling or decision, and shall decide to recognise or execute the ruling or decision when believing that such reorganisation or execution *does not violate the fundamental principles of the law of the People's Republic of China*, impair the state sovereignty, security and *social public interests* or *impair the legitimate rights and interests of the creditors within the People's Republic of China*." (Emphasis added.)

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[13] K. Ong & C. Baxter, *supra* note 8, fn.21.
[14] This was because the major creditors of State-owned enterprises were State-owned banks.
[15] S. Li, *supra* note 6, fn.19.
[16] *Ibid.*
[17] C. Booth, *supra* note 10, fn. 23 at p. 285.
[18] X. Lan, "Outdated Bankruptcy Law Upgraded: China submits new drafts of bankruptcy law to facilitate move towards a full market economy", *The Beijing Review*. Available at http://www.bjreview.cn/EN/200430/Business-200430(B).htm.

Commentators have generally criticised Article 5 for not being clear, for example, what do the concepts of "fundamental principles", "social public interests", etc. actually cover?[19]

Nonetheless, Article 5 represents a significant milestone in the development of China's bankruptcy jurisprudence. In settling the 2006 EBL, the PRC Government also studied the UNCITRAL Model Law on Cross-Border Insolvency, and adopted the principle of universalism from the Model Law.[20] This included incorporating a more universalist approach to cross-border insolvency recognition under Article 5.

RECOGNITION OF UK INSOLVENCY PROCEEDINGS IN PRC

The question of whether a PRC Court would recognise UK insolvency proceedings was tested in the case of *Hua An Funds v Lehman Brothers International Europe (LBIE)* in 2011.[21] This case is particularly interesting as it was the first time the recognition of a UK insolvency proceeding had been put before the PRC Courts since the 2006 EBL had come into force. It was also before the Brexit referendum.

LBIE is a UK entity and part of the Lehman Brothers group which collapsed in September 2008. Hua An Funds is a PRC fund management firm.

In 2006, Hua An Funds invested in principal protected notes, which were designed by LBIE. When the Lehman Brothers group collapsed in September 2008, Hua An Funds feared that the notes might default and filed a petition at the People's Court of Shanghai. In its petition, Hua An Funds claimed damages for an amount of USD96.4 million and sought an attachment of LBIE's assets in the PRC. LBIE argued that, given the commencement of its UK insolvency proceedings, the UK insolvency proceedings should be recognised in the PRC and any individual enforcement action by Hua An Funds should be stayed.

The PRC Court refused to recognise LBIE's UK insolvency proceedings, primarily on two grounds:

- No treaty existed between UK and China for reciprocal recognition of insolvency proceedings;[22] and
- No reciprocity. The PRC Court also found that there was no precedent to demonstrate that the UK Courts would recognise and enforce insolvency rulings rendered by the PRC Courts.

LESSONS FROM *HUA AN FUNDS v LEHMAN BROTHERS INTERNATIONAL EUROPE* (LBIE)

It has been argued that the PRC Court should "not just [look] back to history alone", but should make "some investigation as to whether or not the UK Court would be willing to enforce a Chinese bankruptcy ruling".[23]

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[19] X. Gong, "To Recognise or Not to Recognise? Comparative Study of Lehman Brothers Cases in Mainland China and Taiwan", (2013) *International Corporate Rescue* 240.

[20] W. Wang, "National Report for the People's Republic of China", in D. Faber *et al* (Ed), Oxford University Press, *Commencement of Insolvency Proceedings*, p. 172-173 (2012).

[21] F. Zhang, "从华安基金与雷曼欧洲金融衍生产品投资合作纠纷案看我国相关法律制度的完善" (2012). Available at: http://old.ccmt.org.cn/showexplore.php?id=4148. Zhang, who heard the case and wrote this article, is a Senior Judge at Shanghai High People's Court. The LBIE case was eventually resolved through arbitration, and hence there is no judgement available.

[22] There is a treaty on Mutual Legal Assistance in Criminal Matters published in 2 Feb 2016 – but there is no treaty for Civil / Commercial Matters yet. See: https://www.gov.uk/government/publications/ts-no102016-ukchina-treaty-on-mutual-legal-assistance-in-criminal-matters.

[23] X. Gong, *supra* note 19, at p. 242.

The UK adopted the UNCITRAL Model Law on Cross-Border Insolvency in 2006, pursuant to the UK's Cross-Border Insolvency Regulation 2006. Reciprocity is not a requirement for recognition under the UK's Cross-Border Insolvency Regulation 2006. Arguably, while there is no precedent for UK Courts recognising PRC insolvency proceedings, it does not necessarily mean that if this question came before the UK Courts, the UK Courts would not be willing to recognise PRC insolvency proceedings.

Nonetheless, the LBIE case demonstrates the conservative attitude of the PRC Courts in applying Article 5 and recognition of cross-border insolvency proceedings where there is a lack of an international treaty.

IMPACT OF BREXIT?

Even before Brexit, the PRC Court has refused to recognise UK insolvency proceedings due to the absence of any treaty or evidence of reciprocity.

Indeed, to date, the UK and PRC still do not have any formal international treaty for the recognition of cross-border insolvency proceedings, or for civil and commercial judicial assistance.[24]

As part of the European Union, EU member states are restricted from forming bilateral agreements with third countries on civil and commercial matters. For example, any EU member state wishing to enter into bilateral agreements with third countries on contractual and non-contractual obligations must follow the rules and procedures prescribed under EU Regulation (EC) No. 662/2009.[25] This includes notification (Article 3), assessment by the European Commission (Article 4) and authorisation to negotiate and to conclude (Articles 5 and 8 respectively).

It is also not easy for the EU to enter into a mutual assistance / multilateral agreement on the recognition of cross-border insolvency with China, given that the interests of all the current 28 member states would need to be balanced.

At the time of writing, there are no ongoing negotiations on mutual assistance / multilateral agreement on civil and commercial matters between the EU and China.[26] There is also no report of such negotiations taking place on a bilateral basis between the UK and China.

In the context of trade, it has been suggested that a post-Brexit UK would be better able to sign free trade agreements with China, as the UK could move more "nimbly" to sign bespoke deals to benefit UK's highly specialised economy (which is 80% comprised of services) if unencumbered by the need to balance the interests of 27 other nations.[27]

Similarly, it is envisaged that, with Brexit, the UK will very soon no longer be subject to EU restrictions on its ability to negotiate and settle a bilateral treaty with China (or other countries) for the recognition of insolvency proceedings, or a wider agreement on civil and commercial judicial assistance.

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[24] The latter may be useful in view of Article 262 of the PRC Civil Procedure Law, which provides: "In accordance with the international treaties concluded or acceded to by the People's Republic of China or with the principle of reciprocity, the People's Courts of China and foreign courts may make mutual requests for assistance in the service of legal documents, in investigation and collection of evidence or in other litigation actions."

[25] Regulation (EC) No 662/2009 of the European Parliament and of the Council of 13 July 2009. Available at: http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32009R0662&from=EN.

[26] See: http://trade.ec.europa.eu/doclib/docs/2006/december/tradoc_118238.pdf.

[27] S. Winders, "Brexit and Free Trade: Would a post-Brexit UK be better able to sign free trade agreements with the rest of the world?", the Bruges Group. Available at https://www.brugesgroup.com/images/papers/brexitandinternationalfreetrade.pdf.

If the UK and China considered it to be in their mutual national interests to settle such a treaty between themselves, Brexit presents a golden opportunity to do this and may actually accelerate the recognition of cross-border insolvency between the UK and China.