HARNEYS

China: Solving the zombie problem

The PRC's vision for a modern bankruptcy regime to provide a means of ridding the nation of its zombie businesses while resuscitating the healthier ones was announced earlier this year: on 4 March 2018, the Supreme People's Court of China Notice 53 of 2018 Issued the Minutes of the National Court Bankruptcy Trials Conference (the Notice). We take a look from the outside as to how these changes may affect winding-down of businesses in the PRC and the impact on non-PRC creditors.

Zombie Companies

The term "zombie company" is a graphic one. It is used to describe businesses that generate funds but – after covering running costs, fixed costs (including wages, etc) – only yield enough available profits to cover the interest due on their debts, and not service the debts themselves. They rely on their creditors being satisfied to refrain from bringing insolvency proceedings, effectively postponing indefinitely (and potentially perpetually) the recovery of the principal sums due. Often the creditors in question are banks that have made loans to the companies and are prepared to keep the companies on life support indefinitely.

Following the economic downturn in China in 2015/2016, a number of Chinese industrial companies encountered overcapacity problems, with figures rising to 30 per cent in some industries. This resulted in businesses with underutilised staff and resources and a decline in income with which to repay borrowing that enabled the very expansion that has caused the surplus in productive capacity.

As such, the emergence of zombie companies has been linked with over-productive companies that struggle in the face of shrinking demand, as a result of over-investment. It has been accompanied by a decline in the aggregate profits of Chinese industrial companies: by 2016 state-owned companies saw profits fall to a third of those of private Chinese companies and half of those of foreign-owned companies operating in China.

In September 2015, the Chinese government announced a wide-scale reform programme in order to combat the problem of its inefficient public sector industrial companies. This plan involved encouraging mixed private/public ownership of industrial companies and promoted more mergers to create companies with FOCI (Foreign Investment Control or Influence), not limited by China's borders.

In 2016, the Chinese government announced that it would need to close or reorganise many state-owned industrial companies by 2020, with an expected loss of up to 6 million jobs. Around 1.8 million of these would come from China's coal and steel industries, which represents about 15 per cent of the workforce in that sector.

The Chinese government also identified a number of routes by which the problem of zombie companies could be resolved. Three of these routes have raised concern in the international business community:

1 One route which was identified is for China to export its overcapacity by exporting goods to other states instead of focusing on internal demand. This would open up Chinese industrial products to buyers in other countries; however, flooding foreign markets with cheap goods is likely to result in an increase in duties and tariffs to protect domestic businesses, as has already been seen in the US.

2 The second route is for China to keep stimulating domestic demand by providing domestic buyers with credit. This would enable the zombie companies to sell more products to able buyers; however, addressing a problem that is centred on bad debt by extending credit is unlikely to be a long-term solution.

3 The third route is for China to encourage consolidation of state-owned enterprises. This might conceivably result in the pooling of resources and capacity, with the result that some of the principal debts would be capable of being repaid; however, although some mergers have already taken place there is little evidence that the problem of over-capacity has been solved.

It has been suggested that the Chinese provincial officials are perhaps less willing to take more bold steps such as cutting cheap credit and subsidised utilities to state-owned companies, supervising proper dividends (rather than using all profits to facilitate expansion), and dissolving companies incapable of rehabilitation. The reluctance of provincial authorities to countenance such steps provides a difficult dynamic. Zombie companies continue to provide revenue and essential employment.

The problem is by no means exclusive to China: the BBC has reported on zombie companies in the UK, the US Troubled Asset Relief Programme has had to assist a number of US businesses, and the term was initially coined in relation to Japanese businesses following the collapse of the Japanese asset-price bubble around 1990. It was in relation to this period in the Japanese economy that the phrase "too big to fail" also first appeared.

One option to consider, of course, is winding up the zombie companies. We consider below the current legislative framework in China set against the backdrop of the current approach taken by the Chinese courts and the new vision, as set out in the Notice.

The current legislative framework

Article 5 of the Enterprise Bankruptcy Law of the People's Republic of China (the Enterprise Law) provides that once bankruptcy proceedings are initiated under that law, they do so in respect of all of the debtor's property, whether it is within or without the PRC.

Article 5 also provides that if a legally effective judgment or rule in a bankruptcy case involves property within the PRC, the Chinese court "shall" conduct an examination of the judgment or ruling and "shall" recognise and enforce the judgment or ruling if the following conditions are satisfied:

1 The court of the foreign jurisdiction applies to the Chinese court to recognise and enforce the judgment or order, or requests that the Chinese court recognise and enforce the judgment or order; and

2 The Chinese court's recognition and enforcement of the foreign judgment or order is in accordance either with China's international treaty obligations, or on the basis of the principle of reciprocity; and

3 The foreign judgment or ruling does not—

3.1 violate the basic principles of Chinese law,

3.2 jeopardise the sovereignty and security of the state or public interests, or

3.3 undermine the legitimate rights and interests of creditors of the debtor who are located within China.

There is, therefore, a mechanism by which an order of judgment of a court in a jurisdiction outside China that is seised with insolvency proceedings may be able to enforce that judgment order within China, subject to a number of criteria being met. Article 5 does not appear to preclude recognition or enforcement of a judgment or ruling of a foreign court in insolvency proceedings even where bankruptcy proceedings have been initiated in China in relation to the same debtor, engaging the Chinese court's jurisdiction over the debtor's property world-wide.

It is significant, however, that Article 5 only appears to confer standing to make a request or application under that Article on the court that made the judgment or order. It may be inferred that office-holders who are officers of the court appointing them may be entitled to apply for recognition, but this is not expressly stated.

Secondly, recognition and enforcement appears to be open only to courts in states that have entered into treaty obligations with China or who would recognise a bankruptcy judgment or order of the Chinese courts. It is unclear what the position would be in cases where the foreign court's legislation is drafted in the same terms as the Chinese legislation and both states' position on enforceability is based on reciprocity.

Thirdly, there is presumably a difference between basic principles of Chinese law on the one hand and principles of Chinese law generally on the other. This consideration appears to be similar to the consideration of public policy reasons for refusing to recognise a foreign judgment.

Finally, the court must have regard for the interests of Chinese creditors, and ensure that their rights are not undermined by some feature of the foreign bankruptcy. For the purpose of the Chinese court, therefore, local creditors have special status insofar as a ground to avoid the mandatory language of Article 5 is provided by reference to their interests particularly.

Approaches taken by the Chinese Courts

Earlier decisions of the Chinese courts have pointed towards an opening up to foreign and cross-border insolvency proceedings. In *Sino-Environment Technology Group Limited v Thumb Env-Tech Group (Fujian) Co Ltd*,[1] the Supreme People's Court considered a claim by a company against its sole shareholder for contribution of funds owing under an arrangement by which the registered capital of the company was increased and sums became due from the shareholder.

The company, Thumb Env-Tech Group (Fujian) Co Ltd (***Thumb***), a company registered in China, brought a claim for an order requiring its sole shareholder, Sino-Environment Technology Group Limited (***Sino***), a company incorporated

[1] (2014) Min Si Zhong Zi No 20.

in Singapore, to pay the sum of RMB 45 million. Shortly before the proceedings had been commenced, Sino had been placed into insolvency proceedings in Singapore, and a judicial manager had been appointed to conduct its affairs. The judicial manager had changed Thumb's registered representative, though the new appointee had not been registered with the Chinese Administration for Industry and Commerce (***the AIC***). Sino's new appointee had opposed the commencement of Thumb's claim. An order to pay the sum allegedly due would have come at the expense of Sino's other creditors.

At first instance, the Chinese court granted the claim and ordered Sino to pay the sum claimed. This judgment was upheld on the first appeal, and that decision was appealed to the Supreme People's Court.

The Supreme People's Court allowed the appeal, finding that although the new representative's appointment had not been registered with the AIC, it took effect for the purpose of disputes between the company and its shareholders. Because Sino had appointed a new representative at the time the proceedings were commenced, the company needed that person's *imprimatur*, which it did not have. As such, the proceedings had not been properly brought and the claim had to be dismissed.

Implicit in this decision is the Supreme People's Court's recognition of the appointment of the foreign office-holder of a foreign company and the capacity of that office-holder to exercise Sino's rights as shareholder of Thumb. This went against the decisions of the lower courts, which had refused to regard the change by the foreign liquidator of Thumb's representative as being grounds to dismiss Thumb's claims.

The decision in *Sino-Environment Technology Group Limited v Thumb Env-Tech Group (Fujian) Co Ltd* marked a positive change in the court's attitude towards foreign office-holders and creditors. As stated above, lower Chinese courts had often required that the new appointee be registered *and* that the outgoing representative also sign-off on their replacement's appointment. Neither of these requirements appear to have been required in this case; indeed, the outgoing representative objected to the new appointment. This should result in the saving of considerable time for creditors of non-Chinese companies, which should limit the risk that Chinese shareholders' or former managers may strip assets from failing or failed companies.

The Notice

As stated above, on 4 March 2018, the Supreme People's Court issued the Notice, which contained the minutes of the National Court Bankruptcy Trials Conference, which took place on 25 December 2017 in Shenzhen, Guangdong province.

In short, the Supreme Court has required Chinese courts to recognise the judgments of foreign courts in insolvency or bankruptcy cases pursuant to the various international treaties to which China is a party, or – crucially – under the principle of reciprocity. The Supreme Court also stressed the importance of the government of China negotiating and finalizing further treaties with other nations concerning international and cross-border insolvency, the need for a new means of applying the reciprocity principle, and the cooperation between Chinese courts and trustees in matters concerning cross-border insolvency.

Much of the Notice is concerned with domestic bankruptcy proceedings. Part IV is concerned with what is termed "reorganisation bankruptcy". The preamble to that Part states as follows:

"*As it is believed at the meeting, the reorganization rules reflect the relief function of the bankruptcy laws in a consolidated manner and represent the development trends of modern bankruptcy laws, and hence the people's courts at all levels across the country shall attach great importance to the reorganization work, properly try enterprise reorganization cases, save enterprises in trouble in a market-oriented and law-based means, and continue to improve the relief mechanism for socialist market participants.*"	"会议认为，重整制度集中体现了破产法的拯救功能，代表了现代破产法的发展趋势，全国各级法院要高度重视重整工作，妥善审理企业重整案件，通过市场化、法治化途径挽救困境企业，不断完善社会主义市场主体救治机制。"

This expressly identifies the public and economic interests in saving viable businesses by reorganisation on the one hand and tacitly acknowledges that in cases where this is not possible, liquidation proceedings are necessary. Article 14 clarifies this distinction and uses the term "zombie enterprises" expressly:

"14 Identification and review of enterprises to be reorganized.	"14 重整企业的识别审查。
The targets of reorganization bankruptcy shall be enterprises in trouble having the value and possibility of saving; and zombie enterprises shall be removed from the market decisively through liquidation bankruptcy. If a people's court is able to determine that a debtor conspicuously lacks reorganization value and possibility of saving, taking into account the assets conditions, technology, production and sales, industry prospects, and other factors, when reviewing an application for	破产重整的对象应当是具有挽救价值和可能的困境企业；对于僵尸企业，应通过破产清算，果断实现市场出清。人民法院在审查重整申请时，根据债务人的资产状况、技术工艺、生产销售、行业前景等因素，能够认定债务人明显不具备重整价值以及拯救可能性的，应裁定不予受理。"

reorganization, it shall decide not to grant acceptance."

This is a clear signifier that the current practice of propping up failing companies by permitting them to rely on their creditors to tolerate interest payments indefinitely without any real prospect of being repaid capital sums should come to an end. The language of this article is mandatory: the courts will be required to assess the list of factors (which appears to be exhaustive, though this is not clear) and, if they conclude that the debtor (whether or not it is a zombie company) "conspicuously lacks reorganisation value", "shall" decide not to grant acceptance. It appears that any other alleged justification in allowing an enterprise without such reorganisation value is insufficient: once the court has reached its conclusion, the consequence is mandatory. The Notice does not define the term "zombie enterprises", but as it has gained some currency recently in relation to Chinese companies, it is likely to bear substantially the same interpretation as that given above.

The term "conspicuously" is also not defined, but it is likely that it would need to be shown that the company obviously lacks sufficient value, or that the prospects of it having such value are unrealistic, taking account of its cash-flow and balance-sheet positions; additionally, it may be inferred that in penumbral cases – *ie*, where a company may not have reorganisation value, but it is not 'conspicuous' that it does not – the court has a discretion whether to permit reorganisation or order liquidation.

If a debtor company's affairs pass the "reorganisation value" test, they will be suitable for reorganisation, and the remainder of Part IV supplements and clarifies the Enterprise Law's provisions on corporate rescue. If, however, the court concludes that the company conspicuously lacks reorganisation value (or, presumably, declines to exercise its discretion to order reorganisation in cases that are less clear-cut), it will order liquidation. Liquidation bankruptcy is governed by Part V of the Notice. Again, the preamble to this Part stresses the importance of liquidation in commercial and economic terms:

"As it is believed at the conference, liquidation bankruptcy, as an integral part of the bankruptcy rules, plays a direct role in eliminating outdated capacity and optimizing market resource allocation. For debtors lacking the value and possibility of saving, the debtor-creditor relationships shall be comprehensively and promptly reviewed through liquidation bankruptcy, so as to re-allocate social resources, improve or raise the quality and level of effective social supply, and heighten the role of the Enterprise Bankruptcy Law in guiding the development of the market economy."

"会议认为，破产清算作为破产制度的重要组成部分，具有淘汰落后产能、优化市场资源配置的直接作用。对于缺乏拯救价值和可能性的债务人，要及时通过破产清算程序对债权债务关系进行全面清理，重新配置社会资源，提升社会有效供给的质量和水平，增强企业破产法对市场经济发展的引领作用。"

The importance of companies ceasing to trade and being efficiently dissolved once creditors' claims are satisfied to the best of the companies' abilities, is expressed as being central to economic stability by reference to "eliminating outdated capacity and optimising market-resource allocation." Perhaps another reference to the removal of zombie companies from the Chinese market.
Part IX is concerned with cross-border insolvency, and states as follows:

"49 Cross-border bankruptcy and reciprocity principle.

"When disposing of cross-border bankruptcy cases, people's courts shall properly solve the conflict of laws and contradictions in cross-border bankruptcy and reasonably determine the jurisdiction over cross-border bankruptcy cases. Subject to the principle of equal protection of claims of the same type, the interests of foreign creditors and those of Chinese creditors shall be effectively balanced, and the payment interests of the claims of employees, tax claims, and other prior rights within the territory of China shall be reasonably protected. The negotiations over and conclusion of international cross-border bankruptcy treaties shall be vigorously participated in and boosted, the new means of application of the reciprocity principle shall be explored, and the cooperation between Chinese courts and trustees in the cross-border bankruptcy field shall be furthered, so as to boost the sound and orderly development of international investment.

"50 Rights protection and interests balance in cross-border bankruptcy cases.

"Cross-border bankruptcy cooperation shall be conducted according to Article 5 of the Enterprise Bankruptcy Law. If the people's court

49 对跨境破产与互惠原则。

"人民法院在处理跨境破产案件时，要妥善解决跨境破产中的法律冲突与矛盾，合理确定跨境破产案件中的管辖权。在坚持同类债权平等保护的原则下，协调好外国债权人利益与我国债权人利益的平衡，合理保护我国境内职工债权、税收债权等优先权的清偿利益。积极参与、推动跨境破产国际条约的协商与签订，探索互惠原则适用的新方式，加强我国法院和管理人在跨境破产领域的合作，推进国际投资健康有序发展。

"50 .跨境破产案件中的权利保护与利益平衡。

"依照企业破产法第五条的规定，开展跨境破产协作。人民法院认可外国法院作出的破产案件的判决、裁定后，债务人在中华人民共和

recognizes the judgment or ruling over a bankruptcy case entered by a foreign court, the remainder of the property of the debtor in the territory of the People's Republic of China after full payment of the claims of holders of security interests and employees and social insurance costs, tax payable, and other prior rights within the territory may be dispensed as required by the foreign court."

国境内的财产在全额清偿境内的担保权人、职工债权和社会保险费用、所欠税款等优先权后，剩余财产可以按照该外国法院的规定进行分配。"

Various features are immediately worth noting:

1 Chinese courts are required to resolve questions of jurisdiction "reasonably", and the courts will try to balance the interests of Chinese and foreign creditors effectively, subject to the requirement that claims of the same type in the liquidation or bankruptcy should be protected equally. This clarifies the requirement in Article 5 of the Enterprise Law that the interests of Chinese creditors should not be undermined by the proceedings: it does not require that they have primacy over the interests of foreign creditors whose claims are of the same class; rather, it expressly states that they should be treated equally and their interests balanced in an effective manner.

2 Significant importance is given to the public interest in negotiating and concluding treaty agreements concerning bankruptcy, and the corollary of this is likely to be that Chinese courts should give substantial weight to treaty obligations.

3 The importance placed on the reciprocity principle is also significant: courts are required to explore new means of applying it so as to enable recognition of foreign proceedings and office-holders even where the Chinese courts are not required to do so pursuant to treaty obligations.

4 The Chinese courts are also expressly required to cooperate not only with other courts but with office-holders. The importance of cooperation with foreign office-holders is underlined as being central to the "sound and orderly development of international investment": if the Chinese courts were to disregard or obstruct foreign office-holders, this would have a chilling effect on inward investment in enterprises with business in China.

5 Article 5 remains the touchstone for international and cross-border insolvency matters; however, it appears that courts are required to interpret it in light of the requirements stated in the Notice.

6 The provision of Article 5 requiring that the interests of Chinese creditors be protected from being undermined appears to have been clarified as referring principally to ensuring that certain Chinese claims – such as those relating to secured creditors, employees, social insurance, and tax – retain their priority status. So long as those priority interests are protected, the distribution of the remaining assets will be governed by the law of the foreign court.

In this way, Article 5 is upheld, but is applied in a manner that promotes cooperation between the Chinese courts and the courts of other jurisdictions and the office-holders they appoint.

Conclusion

Though it represents a step in the right direction for cross-border cooperation in the PRC, the Notice sets out broad-brush approaches, and does not go into detail as to how individual cases should be decided. As a result, a number of questions go unanswered, including the following:

1 It is not clear what a court should do in a case where a company is unlikely to have reorganisation value, but cannot be said to be in such a position "conspicuously" (though we have suggested how it may be interpreted above).

2 It does not state how the debtor-creditor relationship can be "comprehensively and promptly" reviewed by the courts, or what such a review should seek to achieve in any particular case.

3 It does not give any examples as to what would amount to the reasonable resolution of a jurisdiction question or the fair balancing of the interests of Chinese and foreign creditors.

4 It does not explain what the court should do if foreign insolvency law adjusts but does not disapply entirely priority claims, such as those of employees.

5 There are no suggestions as to how the court might explore "new means of application of the reciprocity principle".

Taken together, however, the decision in *Sino-Environment Technology Group Limited v Thumb Env-Tech Group (Fujian) Co Ltd* and the Notice draw a fairly clear line in the sand: the Chinese courts will not permit companies that are not financially viable to continue, and will not erect artificial or procedural barriers to the recognition and enforcement of foreign insolvency proceedings, but should positively engage with foreign office-holders, while specified safeguarding key stake-holder interests. The Notice also expresses a disapproving view of zombie companies and the practice of sinking large amounts of public funds into them in the hope that they can be bought out of financial difficulties.
As regards external investors in businesses with assets in China (particularly state-owned enterprises, as these make up the bulk of the zombie companies), therefore, it is likely to be that unless a Chinese creditor falls within one of the protected categories, they will rank together with the debtor's general unsecured creditors. Combined with the approach taken in *Sino-Environment Technology Group Limited v Thumb Env-Tech Group (Fujian) Co Ltd*, this may well result in a significant reduction in the risk that a foreign creditor

might find that all the assets of the debtor have been either squirreled away by unscrupulous shareholders or managers in China, or that Chinese creditors of the same status will be able to recover more than them. This would lead to better returns for external creditors and greater confidence when investing into the PRC.

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