

Recent Legal Developments in China in Response to the Global Financial Crisis

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China has neither been isolated from nor immune to the effects of the economic downturn that continues to ravage financial systems around the world. Investment, especially from the foreign sector, has dropped due to global illiquidity while rates of both contract default and bankruptcy continue to rise. The Supreme People's Court of China (henceforth, the **SPC**) recently announced a series of judicial interpretations in an attempt to clarify certain legal and procedural issues that have arisen as a result of this financial crisis. Among them, the second interpretations (the "**2nd Contract Law Interpretations**") on the PRC Contract Law (the "**Contract Law**") and the general opinions for hearing enterprise bankruptcy cases (the "**Bankruptcy Case Guidelines**"), represent the most important of these new developments.

1. The 2nd Contract Law Interpretations

While 10 years have passed since its enactment in 1999, the Contract Law remains one of the most fundamental and often applied civil or commercial legislations in China. This law has never been amended, but the first judicial interpretations of it by the SPC were published shortly after its inception. However, as the world experiences one of the most severe economic crises of recent memory, measures must be taken in an attempt to mitigate its effects. As confirmed by a senior justice of the SPC in his recent address, the 2nd Contract Law Interpretations were issued primarily for this very purpose. Like any other interpretation by the SPC with regards to a particular piece of enacted legislation, the 2nd Contract Law Interpretations would, in effect, override the current version of the PRC Contract Law should there be any contradiction between them.

The Formation and Effectiveness of Contracts

As a result of general monetary instability and uncertainty, the current financial turmoil has naturally resulted in a considerable amount of repudiated contracts. In recent months, it has often been the case that a party to a contract, if anticipating incapability or difficulty of adhering to a contract, attempts to claim that said contract has not been

officially established, has not yet taken effect, or is otherwise invalid, in hopes of evading the obligations contained therein. Obviously, this practice goes against the basic principle of the Contract Law, which is to honor all contracts to the greatest extent possible. To ensure the intent of the Contract Law is upheld, the 2nd Contract Law Interpretations make clear the SPC's firm tendency to treat contracts formed and effective.

From this point forward, any contract, so long as both the parties concerned and the subject matter are clearly identified, will be considered duly formed. A contract even without an oral or written outline will also be considered formed if the subsequent actions of the relevant parties suggest their willingness to enter into said contract.

Moreover, the formation of a contract will no longer be denied by the absence of official prerequisites for said contract's effectiveness. For example, if any governmental approval or registration in China is legally required for a contract to take effect, said contract will still be considered formed even without said requisite governmental clearance. Should the responsible party fail to acquire the necessary official clearance, the counterparty may, in addition to recovering any resulting losses, seek the specific remedy of handling (to a practical extent) the required approval/registration procedure by itself in order to render the contract effective. This resolves the long-debated issue of whether or not recourse is available to parties involved in a contract that is not yet officially effective. From this point forward, recourse is available, but is limited to such specific action as is required to validate the contract.

In addition, the 2nd Contract Law Interpretations have ensured that compulsory laws and administrative regulations have less of an effect on the validity of a contract¹. Before this new series of interpretations, the Contract Law nullified all contracts in violation of any compulsory law or administrative regulation. Now, the SPC has narrowed the application of that clause, clarifying "compulsory laws and regulations" to include only those laws and administrative regulations expressly affecting the effectiveness of a contract. This restrictive but more precise interpretation will undoubtedly result in less confusion when determining contract validity.

Performance of Contracts

The 2nd Contract Law Interpretations also expound upon the creditor's rights under a contract. Among others, the "revocation right," which refers to a creditor's ability to revoke his debtor's waiver or transfer of any property in bad faith, is enhanced by this new ruling. The 2nd Contract Law Interpretations extend the application of this right to scenarios in which the debtor waives his unmatured obligatory rights or security interests, or grants moratorium in bad faith with respect to his matured obligatory rights.

Another breakthrough of the 2nd Contract Law Interpretations is the unprecedented introduction of a statutory debt ranking system. When a debtor is financially unable to satisfy all its debts, the matured will always prevail over the unmatured claimsⁱⁱ. Furthermore, the ranking of the matured liabilities will, in the absence of a definite agreement among relevant creditors, in sequence depend on their available security amount (less is preferred), unsecured exposures (bigger is preferred), and maturity dates (earlier is preferred). Moreover, when ranking a specific debt, the expense incurred for discharging the same is the most preferred, followed by the accrued interest, while the principal ranks last.

Termination of Contracts and Default Liability

Significant developments are also seen with regards to termination of contracts and default liability, where the majority of contract-related disputes occur.

Premature contract terminations have been increasingly prevalent since the outbreak of the credit crunch last year. As a result, disputes regarding whether or not a contract has been, or can be, annulled before it has been completed are increasing. The 2nd Contract Law Interpretations reflect the SPC's desire to ensure the state of a contract (terminated or still effective) is decided upon as soon as possible, so that business can be carried out smoothly and effectively. Accordingly, if the parties to a contract differ on the desire to terminate said contract, the party opposing such termination would have to file a declarative lawsuit before the appropriate court within 3 months of its receipt of the counterparty's termination request. The elapse of such 3-month period would deprive the objecting party of the chance to be favored by that court.

More importantly, the 2nd Contract Law Interpretations introduce a new statutory cause that allows either party to prematurely terminate a contract - "change of circumstance." Even though it has long been present in China's academic circles, the concept of "change of circumstance" has remained ambiguous in judicial practice until the recent release of these new interpretations. Seemingly a blend of "hardship in performance" and "frustration," it is defined by the 2nd Contract Law Interpretations to be the occurrence of any non-force-majeure and non-commercial-risk unforeseeable material change of objective circumstances that would cause the continued performance of a contract by either party to result in general inequity or would frustrate the purpose of said contract. Either party affected by such "change of circumstance" may file to modify or terminate the contract in question. Obviously, establishing this idea of "change of circumstance" as a legal way to end an unfavorable contract will undoubtedly raise the issue of whether or not the ongoing credit crunch should qualify as "change of circumstance" in various cases. Further authoritative clarification is

therefore eagerly awaited, in that disputes surrounding that issue are expected to surge.

Regarding default liability, the 2nd Contract Law Interpretations more precisely quantify the reasonable range of liquidated damages. Any liquidated damages exceeding the aggrieved party's loss by over 30% would be treated as unreasonable and can be accordingly lowered upon the counterparty's request.

2. The Bankruptcy Case Guidelines

The Bankruptcy Case Guidelines have been issued as a sort of precursor to the SPC's impending judicial interpretation of the PRC Enterprise Bankruptcy Law (the "**Bankruptcy Law**"), the exact promulgation date of which remains publicly unknown. Unlike the 2nd Contract Law Interpretations, the Bankruptcy Case Guidelines are not designed to interpret in detail clauses of existing legislation, but rather to indicate the SPC's general perspective and attitude towards hearing bankruptcy proceedings in the context of the rising trend of corporate insolvency in China.

Principle of Case Filing

The Bankruptcy Case Guidelines stress, first of all, the principle that courts in China should entertain all bankruptcy case applications submitted by insolvent companies or their creditors so long as all the statutory pre-conditions to initiate a bankruptcy proceeding have been met, even if the subject company appears to be trying to escape debt by doing so. When a creditor seeks to institute a bankruptcy proceeding against its debtor, the courts in China no longer can reject the case filing on mere grounds of the creditor's failure to produce evidential materials pertaining to the debtor's asset status, but instead should give first priority to the verification of the solvency status of said debtor.

Reorganization and Debt Settlement Mechanism

It is also worth noting that a company forced to undergo a bankruptcy proceeding has other options available to it besides the obvious one. Before being sentenced to the death of a bankruptcy declaration, the company still has a chance of being reorganized or reaching a debt settlement with its creditors, as stipulated in the Bankruptcy Law.

With the above in mind, the Bankruptcy Case Guidelines urge courts to maximize their usage of the reorganization and settlement mechanism established by the Bankruptcy Law so as to help those financially struggling but commercially promising companies get back on their feet. Specifically, the courts shall, instead of precipitating the bankruptcy and dissolution of an insolvent company, endeavor to coordinate with and

mediate among the creditors, shareholders, employees, and other relevant parties, convincing them of the necessity or desirability to keep the subject company's business afloat or to recompose or reschedule its outstanding debt. Where necessary, courts should take advantage of their statutory discretion to approve a mandatory reorganization effort for said company, notwithstanding a veto by the general meeting of creditors, provided that any creditors objecting to that reorganization scheme are guaranteed to recover at least as much during the reorganization process as they would have normally received if the subject company was liquidated straightforwardly. While it is still reminded in the Bankruptcy Case Guidelines that any application of such discretion by the courts must be well-founded. Abusing such discretion without satisfying minimum statutory pre-conditions is explicitly prohibited.

Employee Settlement Issue

Due to the fact that bankruptcy and the resulting dissolution of insolvent companies will inevitably result in mass unemployment, the courts are required by the Bankruptcy Case Guidelines to, when trying bankruptcy cases, take into account issues of employee settlement and social stability, in addition to complying with existing laws and regulations.

Protecting the employees' interest will therefore be of great importance when any reorganization scheme is considered. Accordingly, issues relating to outstanding wages and the welfare of employees must be resolved separately. The courts are specifically prohibited from approving any reorganization scheme that fails to fully discharge the amount owed to employees or if the proposed settlement plan thereof has not been accepted by the employee representatives or trade union, as the case may be.

Furthermore, the courts are advised to seek assistance from local party committees and governments in dealing with labor settlement matters that may arise over the course of bankruptcy proceedings. Where practical, it is a recommended alternative to settle debts to the employees upfront, making use of financial support from the local government or any interested third party.

Receivership

The system of selecting and appointing a receiver for a company in a bankruptcy proceeding is relatively new in China, and therefore remains largely undeveloped, made even more difficult due to the current marked lack of veteran professional receivers. In an attempt to remedy this, the Bankruptcy Case Guidelines lay down several general principles for lower-level courts to follow when making use of the receivership system.

In particular, the Bankruptcy Case Guidelines clarify that the tribunal hearing the specific bankruptcy case, rather than the relevant court, is vested with the power to decide what sort of receiver to use and which method (random selection or competition) to adopt for choosing among the qualified candidates. Where the case in question is of great significance or difficulty, contested selection is suggested.

As far as the reorganization of an insolvent company is concerned, the appointed receiver will have to not only manage and dispose of the assets in its custody, but also surveil and direct relevant business operations, most important of which being implementing the approved reorganization scheme. Due to the large and complex nature of this responsibility, experience and a proven track record in related industry must be afforded the most consideration when a court appoints a receiver.

In addition, the courts are requested to introduce and establish various systems to train and evaluate a candidate receiver's expertise for administering insolvent enterprises, in an effort to professionalize said candidates for all kinds of bankruptcy cases. This effort is necessary to ensure that China has a sufficient amount of qualified receivers to handle incoming cases of financially insolvent companies.

Protection of Creditors' Rights

The primary purpose of any bankruptcy proceeding is to attain general recovery by all the creditors from their common insolvent debtor. The Bankruptcy Case Guidelines clarify the measures available to creditors in response to, *inter alia*, false or insufficient equity capital contribution by shareholders, undue or illegal disposal of the debtor's assets, and infringement upon the debtor's rights. As a result, the creditors are entitled to directly claim compensation from the debtor's shareholders or infringers to the extent they are held liable, and petition for revocation or nullification of any unjustifiable under-sale of valuable property of the debtor. If the insolvent debtor withholds information relating to its assets, the competent court shall compel its legal representative, senior executives, and shareholders, and may even penalize them by imposing fines, detention, or similar punishment. Post-liquidation claims by creditors against the shareholders, controllers, and/or directors of the bankrupt company would also be upheld where they are liable for impeding or otherwise adversely affecting the liquidation process.

The Bankruptcy Case Guidelines also highlight the importance of ensuring the creditors' participation in the bankruptcy proceeding, especially with regards to the general meeting of creditors and the creditors' committee. Given the prevailing nationwide regional protectionism, the local courts must provide the creditors with full access to all steps of the proceeding and must allow the creditors to vote on important

issues such as any proposed reorganization scheme and debt settlement in accordance with the applicable laws.

Coordination Between a Bankruptcy Proceeding and Other Judicial Proceedings

The bankruptcy proceeding of a company often coincides with one or more ongoing judgment enforcement process or judicial preservations against said company. However, it is important to note that these will remain mutually exclusive. Initiating a bankruptcy proceeding would, in effect, immediately place a hold on all outstanding enforcements and judicial preservations, as reiterated in the Bankruptcy Case Guidelines. Since such a scenario typically involves multiple courtsⁱⁱⁱ, they are required by the Bankruptcy Case Guidelines to coordinate with each other so that the bankruptcy proceeding can go smoothly; *inter alia*, the courts that have frozen the assets of the subject company should forthwith release said assets and allow the appointed receiver to take over said property. Conversely, if the competent court later overrules the petition for bankruptcy or otherwise terminates the bankruptcy proceeding in question, all interrupted enforcements and judicial preservations must be resumed or reinstated immediately.

3. Conclusion

In recent years, we have seen both the promulgation and substantial revision of important legislations in China, such as the Property Law, the Anti-Monopoly Law, and the Patent Law, to name but a few. Inevitably, judicial interpretations and the subsequent implementing of regulations will gradually arise in support of the same. The global financial turmoil we are experiencing continues to press Chinese legislatures and the SPC to constantly adapt quickly outdated civil and commercial legislation to be applicable and appropriate in today's rapidly changing business environment. The 2nd Contract Law Interpretations and the Bankruptcy Case Guidelines are necessary and welcome measures to be sure, but in no way represent the end of this reformation process. Expected major legal developments slated for this year include the SPC's judicial interpretation of the Bankruptcy Law and the Patent Law, the revision of the existing Trademark Law, and the enactment of new regulation for private equity investment funds. As a result, accurate and timely knowledge of these developments in the coming months will be essential for conducting successful business in China.

ⁱ Administrative regulations refer only to such regulations promulgated by the State Council of China.

ⁱⁱ However, all debts will, irrespective of their original due dates, become matured immediately upon the bankruptcy declaration of the debtor.

ⁱⁱⁱ Typically, the jurisdiction of freezing assets of any company depends on the location of said property while the jurisdiction of a bankruptcy proceeding against a company depends on the registered domicile thereof.