China's recognition of foreign insolvency proceedings and VIE structures

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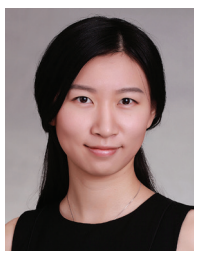
In the last decade, VIE (variable interest entities) structures have become increasingly popular in the People's Republic of China (*PRC*[1] or *China*) as a mechanism to allow foreign investments into China.



For those unfamiliar, a VIE Structure is akin to an agreement-based form of corporate control, designed mainly:

a) to allow foreign investors to hold a controlling interest in a business operating in China (typically in the e-commerce sectors); and
b) as a mechanism for Chinese domestic entities to gain access to international capital markets and foreign mergers and acquisitions through offshore listings.

In summary, through a VIE Structure, foreign investors together with one or more PRC persons (legal or natural) (*PRC Founders*) are able to control an onshore wholly foreign-owned enterprise (*WFOE*) which in turn may enter into arrangements with PRC domestic companies on exclusive licensing or distribution bases.

The key concept which underpins a VIE Structure is that the control and ownership of the domestic licensed company is obtained through various service agreements instead of through direct share ownership. The arrangements are often complex, with checks and balances by way of share pledges on-shore and guarantees offshore by those holding shares in the ultimate investment parent. Through the VIE Agreements, foreign investors are able to invest in, obtain access to and share in the domestic PRC company's profits.

Foreign investment into a Chinese entity through VIE is typically structured as follows:

- the PRC Founders incorporate a company or companies in the British Virgin Islands (*BVI*);
- the BVI company and the financial investors incorporate a company in Cayman Islands (*Cayman*), and this Cayman company may, if the business is successful or capable of promotion, later be listed on an international stock exchange, whether in China, or overseas;
- the Cayman company establishes a shell company in Hong Kong;[2]
- the Hong Kong company establishes a WFOE in China;
- the Chinese WFOE controls the Chinese target companies through a VIE structure. This is achieved by the WFOE signing a series of agreements (known as VIE Agreements) with a domestic licensed company in PRC which holds the necessary licences to operate in the PRC.

Cross-border insolvency issues may arise in such a structure if the founder or the group encounters financial difficulties. If the offshore entities in this structure enter insolvency proceedings, recognition and enforcement of foreign insolvency proceedings may be required in any of the relevant jurisdictions of incorporation – much will depend on where the value lies and how the debts are structured. Typically one finds that there will be a trigger default in the operational ultimate subsidiary or its VIE domestic company, which causes defaults further up the chain and may lead to calls on guarantees given by the Founders who are natural persons.

To facilitate access to capital markets and to ensure investment into China by international investors, increasingly the judicial trend in China has tended toward foreign creditor friendly approaches, to permit investors to have confidence in the safety of their investment, whether direct or via a VIE. Below we look at how that works in practise and how this impacts on the interplay with BVI and VIE structures.

Recognition of foreign insolvency proceedings in China

Article 5 of China's *Enterprise Bankruptcy Law (EBL)* provides the basis and criteria for recognising foreign insolvency judgements and orders. Under Article 5, Chinese courts may recognise and enforce foreign insolvency judgements and orders affecting a debtor's assets within China on the following conditions:

1) the request for recognition and enforcement is based on a treaty or convention to which China is a party or the principle of reciprocity;
2) granting recognition and enforcement will not violate the basic principles of Chinese law; nor will it be against the national sovereignty, national security or public interest, or prejudice the legitimate interests of the creditors in China.

The considerations are not atypical of many western insolvency recognition regimes. Whilst there has been no reported foreign insolvency judgement or order recognised by Chinese courts under Article 5 of the EBL, the reason for that may lie in the fact that China has not adopted the UNCITRAL Model Law on Cross-border Insolvency (*UNCITRAL Model Law*) nor entered into any treaties for the cross-border recognition of insolvency proceedings. However, Chinese courts have long adopted *de facto* reciprocity, albeit a stringent standard, to permit the establishment of recognition, which in recent years has gained prominence in China.

The 2018 meeting minutes of the Supreme People's Court (*SPC*) on bankruptcy cases encouraged Chinese courts to explore a "new method" of applying reciprocity: this was taken largely to refer to the recent developments on the expansion of reciprocity in civil and commercial areas. For instance, the SPC issued opinions regarding the Belt and Road Initiative successively in 2015 and 2019, proposing a loosening of the criteria for reciprocity so as to promote mutual recognition and enforcement of judgements. That broadening of what was once a more restrictive approach in the civil and commercial judicial sphere may increase the chances of reciprocity in cross-border insolvency matters.

Consequently, Chinese courts are arguably more likely to acknowledge the existence of reciprocity as a principle for recognition of foreign insolvencies, particularly in the following circumstances:

- The relevant jurisdiction where the insolvency has been commenced has already recognised Chinese insolvency proceedings. A few jurisdictions have recently done so. Courts in the US recognised the Chinese bankruptcy proceedings of Zhejiang Topoint Photovoltaic Co, Ltd. and Reward Science and Technology Industry Group respectively in 2014 and 2019. More recently, a Hong Kong court recognised the appointment of bankruptcy administrators of a Chinese company, CEFC Shanghai International Group Limited in January 2020, which was the first cross-border insolvency case recognising Chinese bankruptcy administrators in Hong Kong.
- Even where a relevant jurisdiction has not yet recognised Chinese insolvency proceedings, the Chinese Court may also look to whether the jurisdiction could theoretically recognise Chinese insolvency proceedings where there to be a hypothetical application. For instance, jurisdictions that apply the UNCITRAL Model Law and certain common law jurisdictions may not require *de facto* reciprocity to be demonstrated for cross-border insolvency recognition to be effected; where such jurisdictions may incline to recognise Chinese insolvency proceedings, the Chinese Court may consider that a factor when determining recognition.

That being said, the standard of reciprocity for cross-border insolvency has yet to be tested before the Chinese courts and as such it is an area of increasing interest amongst academics, lawyers and the investment community alike.

In the VIE structure as mentioned above, financial investors as creditors (whether as redeeming shareholder or under the VIE arrangements) may initiate their recoveries against an individual founder. Typically, that will occur offshore given the prevalence of interests held through offshore entities. Given that the individual founder will usually have assets in China, an issue will arise as to whether the enforcement can be recognised or whether insolvency proceedings of the individual founder may be brought in China. However, in China, there is currently no personal bankruptcy law.

Certain cities in Zhejiang Province are exploring a centralised clean-up of personal

debts, which system has characteristics consistent with a personal bankruptcy regime. Shenzhen City is exploring the question of personal bankruptcy system but the draft of the regulation remains at the time of writing under review.

Due to the lack of definitive personal insolvency regime, it is unlikely that a Chinese court will find itself able to recognise foreign insolvency proceedings brought against an individual. The Chinese court may find such recognition against the public interest and accordingly refuse to recognise any foreign personal insolvency order.

Recognition of foreign insolvency officeholders

Although Chinese courts have not yet recognised foreign insolvency proceedings under Article 5 of the EBL, they have recognised the status of a foreign insolvency officeholders' appointment. The SPC meeting minutes on maritime and commercial cases with foreign elements issued early in 2005 made clear that, if the foreign party to the legal proceedings in China becomes bankrupt or enters liquidation during the proceedings, the court shall notify its insolvency officeholder to participate in the proceedings.

In judicial practice, Chinese courts have also recognised the capacity of foreign insolvency officeholders to represent the debtor in the legal proceedings. An important case is *Sino-Environmental Technology Group v Thumb Environmental Technology Group*[3] heard by the SPC in 2014. Without specifically requiring the recognition of the appointment of the foreign insolvency officeholders, this case confirms that foreign insolvency officeholders can act on behalf of the debtor in the PRC in accordance with the law of the place where the debtor is registered.

This may facilitate foreign insolvency officeholders taking certain actions in China without applying for recognition. For instance, in the VIE structure as mentioned above, if the offshore company in liquidation has Chinese debtors, the foreign insolvency officeholders may, on behalf of the offshore company, initiate legal proceedings in China against its Chinese debtors, without applying to a Chinese court for recognition of the appointment of the foreign insolvency officeholders.

However, without a Chinese courts' recognition of the foreign insolvency judgement/order, the foreign insolvency officeholders will not be granted judicial assistance and are therefore unable to perform their functions in full in China. For example, without the assistance granted by the court, the foreign insolvency officeholders are unable to protect the foreign debtors' assets in China, such as by preventing any disposal of the debtors' assets in China.

In order to perform their functions, the insolvency officeholders may apply to a Chinese court for recognition of the relevant foreign insolvency judgement/order. However, it remains unclear what assistance the court may grant to foreign insolvency officeholders if the court recognises the relevant foreign insolvency judgment/order. Other than Article 5, the EBL does not provide any detailed rules on cross-border insolvency. The SPC meeting minutes on bankruptcy cases issued in 2018 considered that cooperation on cross-border insolvency should be promoted, but did not provide any specific guidance on the extent and type of assistance that may be granted by the Chinese courts.

The specific guidance not having been promulgated, were a Chinese court to recognise foreign insolvency proceedings, assistance should be granted as if the foreign debtor had entered into bankruptcy proceedings in China. Given that this is not made clear by the EBL, the recommended approach is to ensure that powers and effects are included in the order of the Chinese court recognising foreign insolvency proceedings. For instance, once the Chinese court recognises the foreign court judgement/order on initiation of the foreign insolvency proceeding, a stay should be available as if this were a bankruptcy proceeding in China, in which case any preservation measures existing on the debtor's assets would fall away, and any enforcement proceedings against the debtor should be suspended, etc.

Even if the Chinese court recognising foreign insolvency proceedings issues such a detailed order including therein specific powers and effects, it is still quite uncertain whether

and how other courts and arbitration institutions in China will honour such orders, due to lack of detailed rules and precedents. According to a speech of a SPC judge in a bankruptcy forum, the SPC is currently promoting amendments to the EBL, which will provide more detailed rules on cross-border insolvency, including but not limited to jurisdiction, status of foreign insolvency officeholder and foreign creditors, conditions and methods of provision of assistance.

Since the relevant laws at present preclude personal bankruptcy, this is only of interest where the debtor is a corporate as opposed to an individual natural person. So where does that leave enforcement of debts as against individuals domiciled in China with assets offshore but where the value is locked in the PRC?

The case of *Industrial Bank Financial Leasing Co Ltd v Xing Libin* BVIHC (Com) 0032 of 2018 (*Industrial Bank*) in the BVI is instructive on that point. The BVI Court not only recognised and enforced judgments from the Courts of the PRC but also appointed receivers by way of equitable execution to take control of a PRC judgment debtor's assets being shares in a BVI incorporated vehicle, to maximise enforcement for a judgment creditor.

This case bodes well for comity between the BVI and the PRC and may very well pave the way for mutual recognition and assistance between the two jurisdictions, which, given the prevalence of BVI companies in offshore VIE structures and the issues in pursuing any personal recovery against individual natural persons in China, will be a useful tool for recovery. Once appointed, the receivers may use their powers, to realise the value from the shares by appointing themselves directors of the company and thereafter taking corporate steps to liquidate the assets of the company or put the company into voluntary liquidation to satisfy the judgment debt.

In permitting the appointment of receivers, the Court was especially persuaded by the fact that a direct sale where the value of the underlying assets was unknown could result in a discounted recovery, therefore prejudicing both the judgment creditor and debtor. Therefore, the appointment of a receiver was the only available realistic prospect for the judgment creditor to enforce its judgment in the short term.

In the absence of a personal bankruptcy regime in the PRC, the decision in *Industrial Bank* allows recovery as against individuals offshore as well as opening the door to comity for BVI judgments in the PRC. This is likely to be treated as the first step to permitting wider recognition of cross-border insolvency between both BVI and PRC, particularly where neither has enacted the UNCITRAL Model law.

In the event of any developments in terms of personal bankruptcy laws, cross-border recognition on the basis of comity will likely follow, if that regime is developed in the PRC. In the meantime, investors can take comfort that both China and the BVI have a clear path of actual comity to allow for enforcement should the need arise.

Singapore and Hong Kong approaches to facilitating cross-border insolvency proceedings

Since both jurisdictions are used as part of the VIE structure, it is useful for investors to know what available assistance there is for cross-border recognition at the mid-tier level, should such occasion arise.

Hong Kong is not a signatory to the UNCITRAL Model Law and so reliance is placed on principles of common law to assist with foreign insolvency proceedings, such assistance being determined on a case-by-case basis. The recent case of *CEFC Shanghai International Group Limited* [2020] HKCFI 167[4] is the first case where the Hong Kong Court recognised PRC insolvency proceedings and made an order for assistance. The Court summarised common law recognition and assistance as follows:

a) The foreign insolvency proceedings must be collective insolvency proceedings, commenced in the debtor's country of incorporation and the country of incorporation must be a jurisdiction with a similar insolvency regime to Hong Kong.
b) There is no requirement that the foreign jurisdiction must also recognise insolvency officeholders appointed by the Hong Kong courts, the country of incorporation must be one that aims to promote a unitary

approach in transnational insolvencies and the degree to which the foreign jurisdiction recognises officeholders appointed by the Hong Kong courts may be relevant to this determination.

c) The Hong Kong Court will offer assistance to the foreign officeholders by applying Hong Kong insolvency law, subject to certain parameters, on recognition.

d) The assistance sought should not enable the foreign officeholders to do something which they could not do under the law by which they were appointed and the power of assistance is only available to the extent that it is necessary for the performance their functions.

e) An order granting assistance must be consistent with the substantive law and public policy of the assisting court.

In contrast Singapore has adopted the UNCITRAL Model Law to enhance Singapore's status as an international centre for debt restructuring. Following its adoption, Singapore courts must recognise a foreign proceeding if certain stipulated conditions are met, unless recognition would be contrary to Singapore's public policy. Foreign representatives can apply for recognition of foreign insolvency which will be recognised as a foreign main proceeding if it is taking place in the state where the debtor has its centre of main interests (*COMI*). This is presumed to be location of the registered office or habitual residence of the debtor.

In *Re Zetta Jet Pte Ltd and others (Asia Aviation Holdings Pte Ltd, intervener)* [2019] SGHC 53 (heralded by practitioners as Singapore's landmark judgment on recognition of foreign insolvency proceedings under the UNCITRAL Model Law), the court held that the statutory presumption should not be considered a rebuttable presumption that must be disproved on the balance of probabilities, but rather be used as a starting location of the COMI, capable of displacement by furnishing evidence to the contrary. *Re Zetta Jet* held that the relevant date for such determination was the date of filing of the recognition application.

Particular weight is likely to be placed on factors such as (a) the location of control of the company, the analysis of which could include the activities of the entire group of companies and not just of the debtor company; (b) dealings with third parties (customers, creditors, vendors, suppliers) insofar as where these parties would have considered the debtor in question to have its base; and (c) the location of creditors. The Singapore court also made clear that the location from which a foreign representative was operating from is not a relevant factor in determining the COMI of a debtor.

Adoption of the Model Law more generally

Across Asia, adoption of the UNCITRAL Model Law has not been widespread. For example, Malaysia is not a signatory to, nor has it adopted the UNCITRAL Model Law in its domestic legislation. Since updating its companies law in 2016, which greatly enhanced tools for domestic insolvency matters, there is no codification of any cross-border arrangements or measures by which foreign courts could cooperate on insolvency matters.

The Courts are largely left to interpret the current legislation and to allow cross border judicial cooperation on the basis of comity. In the event of a winding-up in Malaysia of a company incorporated in another jurisdiction, Malaysian law requires that assets of the foreign company which are located in Malaysia to first be ring fenced and applied towards domestic liabilities, before the assets can be turned over to a foreign insolvency office holder.

Commentary from practitioners who have been consulted are hopeful that the well known case of *Singularis* opens a gateway for more information sharing and for foreign liquidators to obtain wider orders for examination of persons in connection with the affairs of a company, by evolution of the common-law in the future.

Another case in point is Thailand, which adopts a civil law system based historically on the French Civil Code. The Thai insolvency and restructuring regime does not recognise cross-border insolvency issues. Indeed, the key legislation in the area, the Thai Bankruptcy Act, [the TBA] expressly provides (section 177 of the TBA) that *"the receivership or bankruptcy under the law of any other country has no effect on the debtor's property located in [Thailand]"* and practitioners consider that it is fairly clear

that Thai Courts are unlikely to cooperate with foreign courts in insolvency proceedings.

While some commentators are pushing for Thai adoption of the UNCITRAL Model Law, and the Thai government, through the Legal Execution Department, the Ministry of Justice has studied the effect of implementing some of those laws, this has not yet been adopted. Thailand is not presently a signatory to any international treaties or arrangements relating to insolvency and restructuring processes.

Ultimately if a foreign creditor wishes to, he or she will have to prove in the bankruptcy proceedings in Thailand, declaring any distributions that have been made to the creditor in respect of a Thai debtor's estate outside of Thailand and agree for that to form part of the Thai debtor's total estate to debtors in Thailand.

Notes:

This article is not intended as legal advice nor a substitute thereof and no reliance may be placed on its contents.

1 In this article, any reference to the PRC or China excludes Hong Kong, Macau and Taiwan.

2 Or, less, frequently Singapore.

3 (2014) Min Si Zhong Zi No 20 Civil Ruling.

4 Following *Re Supreme Tycoon Limited* (08/02/2018, HCMP833/2017).

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