



Freshfields Bruckhaus Deringer

# Demystifying Chinese insolvencies – all roads lead to the Mainland

Nick Stern



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Chinese firms acquiring foreign assets has been a hot topic for some time. But one often overlooked question is what happens to those overseas assets if the Chinese business fails?

Given the scale of Chinese investment overseas and the financial problems currently being experienced by many Mainland businesses, this question is of growing importance. Two recent decisions – one in Hong Kong and one in New York – address this issue and point to the growing demystification and recognition of Chinese insolvency law outside China. What these decisions also show is that creditors outside China may increasingly find that their only way to recover debts is to engage with the Chinese insolvency process.

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## | An international free-for-all?

When a business goes into liquidation in China, its creditors are prevented from taking individual actions against the business' Chinese assets. Instead they have to participate in a collective liquidation process. However, what about assets located outside China? Can foreign creditors ignore the Chinese liquidation process and enforce their claims against the foreign assets?

## | The Hong Kong angle

Mr Justice Harris in the Hong Kong Court of First Instance had to consider this issue in a judgment delivered yesterday (*Re CEFC Shanghai International Group Limited*, 13 January 2020). CEFC, a Shanghai-based investment company, is in liquidation in Mainland China, but has substantial assets in Hong Kong. A creditor was seeking to enforce against those Hong Kong assets. As a result, the Chinese court-appointed administrators of CEFC applied to the Hong Kong court to recognise the Chinese liquidation and protect the Hong Kong assets from pending enforcement. Despite the Hong Kong court routinely recognising foreign insolvencies, this was the first application to the Hong Kong court to recognise a Mainland insolvency.

### The legal test for recognition involves two questions:

- 1 Have the foreign proceedings been opened in the company's country of incorporation? (CEFC was incorporated in China and so this requirement was met); and
- 2 Are the proceedings collective insolvency proceedings?

**One of the most notable aspects of this decision is that the Judge, when answering this second question, sought to draw out some of the key similarities between Hong Kong and the Mainland's insolvency laws. In particular, he noted that insolvency law under both systems provides for:**

- a moratorium on creditor claims;
- all of a debtor's assets to be encompassed in the proceedings and to be distributed to creditors on a parri passu basis; and
- the appointed insolvency officeholders to have similar powers and duties.

As a result, in his view, there was no doubt that the Chinese insolvency proceedings were collective in nature and should be recognised, thereby protecting CEFC's Hong Kong assets against enforcement by creditors.

Another eye-catching aspect of this decision is that it seems clearly aimed, at least in part, at a Mainland audience. There are two reasons for inferring this. First, Harris J addressed the thorny mirror issue of whether a Mainland court would ever be prepared to recognise a foreign insolvency. None has done so to date, despite the fact that the main Chinese insolvency legislation – the Enterprise Bankruptcy Law (at Article 5) – expressly envisages such recognition. The Judge noted that in Hong Kong there is no legal requirement for reciprocity when recognising a foreign insolvency. Nevertheless, he stated that the extent to which greater assistance is provided to Mainland insolvencies by Hong Kong (and other) courts in the future is likely to be influenced by the level of cooperation and recognition given by Mainland courts to foreign insolvencies. Second, unlike in Hong Kong, reciprocity is a prerequisite to recognition of foreign proceedings for Mainland courts. It must therefore be hoped that the Mainland courts can take some comfort from the recognition given to Mainland proceedings by the Hong Kong court in this decision when they come to consider in the future whether to recognise Hong Kong insolvency proceedings in China.

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## In re Reward Science and Technology Industry Group Co., Ltd

The CEFC decision comes only a few months after the decision of the US Bankruptcy Court for the Southern District of New York to grant Chapter 15 protection to Reward, a Chinese incorporated consumer goods group. This meant that Reward's offshore creditors, some of whom had contested the application, were prevented from enforcing their claims against Reward's assets in the US. This is understood to be the first contested Chapter 15 application for a Chinese company.

Reward had debts of US\$1.3bn, which prompted a liquidity crisis leading to an insolvency filing in Beijing in April last year. US\$200m of that debt was comprised of US dollar-denominated offshore notes, with the remainder of the debt arising from borrowing in China. Despite the Chinese insolvency, two groups of noteholders launched proceedings in New York. The Chinese court-appointed administrator applied to the US Bankruptcy Court to recognise the Chinese proceedings under Chapter 15 to stay all claims against the debtor in the US.

The noteholders objected to the application, raising a number of arguments including that, as non-Chinese creditors, they were receiving discriminatory treatment in the Chinese insolvency proceedings. The US Bankruptcy Court, nonetheless, made the Chapter 15 order in Reward's favour. This meant that the offshore creditors could not enforce their claims against Reward's offshore assets but instead had to participate – together with Reward's onshore creditors – in its Chinese liquidation process.

Freshfields in New York and Hong Kong acted for the Chinese administrator that made the Chapter 15 application.

## Growing engagement and cooperation

Both of these decisions show that foreign courts are increasingly prepared to engage with and seek to understand the Chinese insolvency process. Given the growing financial problems being faced by many Chinese businesses, this trend is likely to continue. How far it will go, however, will depend on whether foreign creditors are seen to be treated fairly in Chinese insolvencies and whether there is similar engagement and understanding by the Chinese courts.

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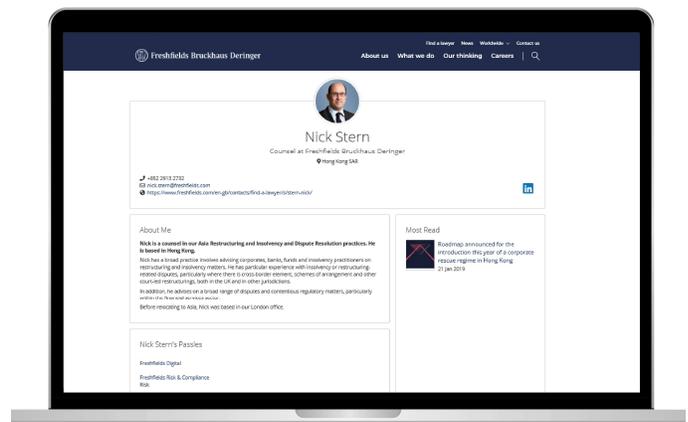
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