Corporate Rescue in Asia – Trends and Challenges

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Abstract

The recent global financial crisis has highlighted the need for countries to have effective mechanisms — both statutory and otherwise — to support and encourage corporate rescue. This article considers the trends and challenges facing jurisdictions in Asia as they enact, implement and refine their laws on corporate rescue with specific reference to the proposed reform to corporate rescue laws in Hong Kong and the impact of mainland China on the region as a whole. The issues and case studies are considered by reference to three legal indicators: (1) the degree to which creditors may initiate corporate rescue; (2) the degree to which management of the debtor company has a formal role in corporate rescue; and (3) the degree to which the rights of foreign investors and creditors are recognised and supported by government agencies and the courts.

This article identifies a general trend in Asia towards recognising the importance of laws governing corporate rescue. However, there are ongoing philosophical differences between jurisdictions over the objectives of insolvency law, the rights and powers of creditors and debtor companies in initiating and implementing corporate rescue and the interests of broader stakeholders, including the interests of governments in protecting employees and achieving economic stability. In addition, experience to date highlights the extent to which corporate rescue can be hamstrung by cross-border obstacles and, in the case of mainland China, by the active and direct role that local governments play in the process.

I Introduction

The recent global financial crisis has highlighted the need for countries to have effective mechanisms — both statutory and otherwise — to support and encourage corporate rescue.[1] This is particularly important where companies encounter financial difficulties as a result of shocks brought about by systemic financial or economic collapse and would benefit from corporate rescue mechanisms to help preserve their ongoing viability. In some countries, the existing framework has been found to be wanting and the crisis has triggered a

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1 Broadly speaking, 'corporate rescue' can be defined as the process by which companies in financial difficulty attempt to rescue themselves from insolvency. It embraces both formal statutory procedures and informal non-statutory procedures.

new wave of legislative reform proposals.[2] In other countries, the existing mechanisms have been perceived to be insufficient and, for better or worse, have been supplemented by extensive government interventions.[3] As Wood noted in June 2009, the global financial crisis 'is likely to bring in its train a re-examination of corporate rescue statutes as a way of protecting the economy.'[4]

Over the past decade, many countries in Asia have experienced significant reform to insolvency laws and corporate rescue mechanisms. Spurred on by the fallout from the Asian financial crisis in the late 1990s, countries such as Indonesia and Thailand have enacted and implemented western-style insolvency laws with varying degrees of success, and these laws have incorporated various corporate rescue mechanisms. More recently, in 2006, China promulgated the *PRC Enterprise Bankruptcy Law*,[5] its first unified law on corporate insolvency. This, too, incorporates corporate rescue mechanisms.

The establishment of an efficient and effective corporate rescue mechanism presents challenges for all jurisdictions, not just developing jurisdictions. There are several reasons for this, four of which are noteworthy. First, there are many different corporate rescue models from which countries can choose and these require a range of issues to be considered and resolved. These issues range from whether creditors should be able to initiate the process to whether the debtor-in-possession ('DIP') model should be adopted.[6] The need to consider a broad range of models means that reform can be controversial and time-consuming.

Second, the choice of model is a reflection of where jurisdictions stand in relation to a broad range of sensitive political, social and economic issues, including the following:

- where to strike a balance between the rights of debtors and the rights of creditors, particularly secured creditors;[7]
- the extent to which the rights of stakeholders other than the debtors and the creditors (eg employees) should be taken into account and protected;[8]
- the role of the existing management in corporate rescue;[9]

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2 See Part IV below in relation to Hong Kong.

3 The debt restructuring of General Motors in the US and JAL in Japan are two examples.

4 Philip Wood, 'The philosophy of insolvency rescue' (2009) 6 *Journal of International Banking and Financial Law* 309.

5 *Enterprise Bankruptcy Law of the People's Republic of China* (People's Republic of China) National People's Congress, 27 August 2006 ('*PRC Enterprise Bankruptcy Law*').

6 See Part IV (C). Under the DIP model, the debtor company retains possession of its assets and its management remains in control subject to the supervision of the court. For a discussion of the various models and the associated legal issues, see Philip Crutchfield and Stacey Steele, 'Corporate Reconstruction in Australia, United Kingdom and the United States: Formal and Informal Workouts' in Timothy Lindsey (ed), *Indonesia: bankruptcy, law reform and the commercial court: comparative perspectives on insolvency law and policy* (Desert Pea Press, 2000), 156.

7 This was a critical issue in the drafting of the *PRC Enterprise Bankruptcy Law*. See Andrew Godwin 'A Lengthy Stay? The Impact of the PRC Enterprise Bankruptcy Law on the Rights of Secured Creditors', (2007) 30 *University of New South Wales Law Journal* 755.

8 This has been a critical issue in Hong Kong and also in mainland China, where much importance is placed on social stability and achieving an 'harmonious society'. See Part V in relation to mainland China.

9 See above n 6.

- the role of the courts and the nature and extent of their supervisory powers;
- the extent to which government should intervene and play an active role in facilitating the process;[10] and
- the way in which tensions between the various players should be resolved.[11]

Third, many broader issues come into play concerning where a jurisdiction should be ranked amongst its peers, particularly in terms of maintaining its competitiveness from an economic and foreign investment perspective.[12]

Fourth, in order to be implemented successfully and effectively, laws on insolvency and corporate rescue need to form part of a comprehensive framework of laws that deal with related issues, including the duties and liabilities of directors and insolvency administrators, the role and powers of courts and the availability and priority of asset security.[13]

The purpose of this article is to consider the trends and challenges facing jurisdictions in Asia as they enact, implement and refine their laws on corporate rescue with specific reference to the proposed reform to corporate rescue laws in Hong Kong and the impact of mainland China on the region as a whole.[14] Hong Kong is significant because of the way in which it highlights the challenges facing developed jurisdictions as they consider which model to adopt, and also because of its close economic relationship with mainland China. Mainland China is significant because of its economic importance, particularly its increasing relevance in cross-border insolvency proceedings, and also as an example of the extent to which corporate rescue mechanisms are vulnerable to being undermined and emasculated by government intervention and the subordination of law to political priorities.

Mainland China is also significant in terms of highlighting the need for lawyers, scholars and those engaged in law reform to avoid the temptation to assess the effectiveness of an insolvency law framework solely from a western perspective and to view insolvency law as something that can be easily standardised or harmonised in a regional or global sense.[15] It would be easy to dismiss the role and involvement of local governments in China as operating

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10 See Part V(B) in relation to mainland China.

11 The pursuit of corporate rescue inevitably pits certain players against each other and tests the resilience of the legal system. See the discussion in Part III(B) below in relation to *Re Legend International Resorts Ltd* [2006] HKCA 67 ('*Re Legend*').

12 Statutory corporate rescue laws are often used as an indicator of a jurisdiction's maturity and the extent to which it is considered to be 'investor-friendly'. See, eg, the US Department of Commerce, *Country Commercial Guides* <http://www.buyusa.gov/home/export.html>, which take insolvency law criteria into account.

13 See the comments of Hon Rogers VP in *Re Legend International Resorts Ltd* [2006] HKCA 67 [34].

14 This article does not undertake a comprehensive review of jurisdictions in Asia. Rather, its objective is to look at the position in Hong Kong and mainland China as examples of the trends and challenges that arise.

15 Experience indicates that even in those Asian jurisdictions in which Western insolvency models have been adopted, there have been significant teething problems. See Timothy Lindsey and Veronica Taylor, 'Rethinking Indonesian Insolvency Reform: Contexts and Frameworks' in Lindsey, above n 6, 2.

outside the insolvency law framework or as indicative of the absence of 'rule of law' by western standards. However, even though it is fair to say that the role of local governments in China diverges from the global mainstream, it is also fair to say that it is broadly consistent with China's own legal system and the unique — albeit indeterminate — nature of China's 'socialist market economy'.[16]

This article is organised as follows: Part II establishes the context for a discussion of the central themes in this article, providing a general overview of corporate rescue in Asia by reference to three legal indicators. Part III discusses two case decisions in which these themes have come to the fore. Part IV looks at the proposed reform to corporate rescue in Hong Kong and explores some of the related challenges. Part V considers the position in mainland China and discusses a case study in which the role of local government has been particularly critical. Part VI concludes by making some general observations concerning the trend towards corporate rescue in Asia, the ongoing philosophical differences over the objectives of insolvency law and the divergence between Asian jurisdictions in terms of the models that have been adopted.

II Overview of Corporate Rescue in Asia

Given the diversity that exists in corporate rescue mechanisms, it is difficult, if not impossible, to categorise Asian jurisdictions by reference to specific models.[17] Although jurisdictions have borrowed from each other and exhibit certain similarities, the differences that arise between legal systems and the evolution of insolvency law mean that any attempt to assess the effectiveness of corporate rescue by reference to specific models can be futile or misleading.

Rather, it is more useful to identify certain macro or 'big picture' indicators as a means of distinguishing between jurisdictions and the corporate rescue models that they have adopted.[18] These legal indicators are helpful in terms of creating a conceptual framework for considering the issues in this article. They reflect issues that all jurisdictions have had to struggle with as they seek to enact and implement laws on corporate rescue.[19]

The following legal indicators are relevant to the analysis in this article:

- the degree to which creditors may initiate corporate rescue;
- the degree to which management of the debtor company has a formal role in corporate rescue; and

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16 See Part V (B).

17 For example, the DIP model in the United States, voluntary administration in Australia or judicial management in Singapore.

18 The micro legal indicators include issues such as the nature and extent of moratoria on creditor enforcement actions, the rights of secured creditors, the availability of set-off, contract cancellation, cram-down rights and the degree of control by the courts. For details of some of these micro indicators, see UNCITRAL *Legislative Guide on Insolvency Law* <http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf>.

19 Although these macro indicators provide a somewhat blunt tool for comparing jurisdictions, they nonetheless offer useful insights into the normative basis on which jurisdictions have adopted corporate rescue models.

- the degree to which the rights of foreign investors and creditors are recognised and supported by government agencies and the courts.

These indicators reveal philosophical differences in relation to the utility of corporate rescue models and the most appropriate ways in which the objectives of corporate rescue should be met. The first indicator speaks to the role of creditors and the tests that are applied to determine when creditor-initiated procedures should be implemented. Related to this are questions about the capacity of creditors to assess whether financially distressed companies qualify for corporate rescue and the practical difficulties that arise when creditors meet opposition or resistance from management.

The second indicator speaks to the potential advantages that arise when management is permitted to play an active role in corporate rescue — particularly in the context of the family-controlled small and medium enterprises ('SMEs') that are common in Asia — and the associated risk that the process is abused to defraud or disadvantage creditors.

The third indicator speaks to the xenophobia and distrust that some jurisdictions still harbour in relation to foreign investors and creditors, particularly where questions of control and national interest come into play. These questions may arise either in the context of domestic insolvency proceedings or in cross-border insolvency proceedings.

Most Asian jurisdictions allow creditors to initiate corporate rescue proceedings. These include Japan, China, Korea, Singapore, the Philippines, Thailand, Taiwan and Vietnam. The exceptions include Hong Kong, which is examined in detail below, and Indonesia, which has only one formal corporate rescue mechanism, a 'suspension of payments', under which a debtor company may petition a court for a 'provisional moratorium' on action by creditors in order to allow the debtor company to propose a composition plan to its creditors.[20]

A smaller but still significant number of countries permit management to have a formal role in corporate rescue proceedings, including retaining control under a debtor-in-possession ('DIP'), or modified DIP, system. In Indonesia, if a 'suspension of payments' is granted, the debtor will be entitled to manage and dispose of assets jointly with an administrator and under the supervision of a judge.[21] In Japan, civil rehabilitation involves a modified DIP system, 'whereby the debtor in possession administers the estate under the direction of an attorney appointed as supervisor by the competent court.'[22] In China, although a restructuring is required to be supervised by the administrator, there is provision for the debtor company to apply to manage its assets and business itself in place of

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[20] Asia Development Bank, *The Asia-Pacific Restructuring and Insolvency Guide 2006* (Global White Page, 2006) ('*ADB Guide*') 80.

[21] Ibid.

[22] Ibid 91.

the administrator.[23] Vietnam and the Philippines also make provision for management to have a formal role in corporate rescue proceedings.[24]

Even where comprehensive laws on corporate rescue exist, the effectiveness of corporate rescue — the extent to which it supports attempts to avoid bankruptcy liquidation and operates alongside or as an alternative to other measures such as government intervention — needs to be viewed in the context of the practical realities. In addition to the realities associated with the operation of the legal system (eg the independence and competence of the courts), three realities can be identified in this regard. First, some jurisdictions have traditionally preferred private out-of-court mechanisms that are supported by non-binding guidelines on corporate rescue. In Hong Kong, for example, private corporate rescue mechanism are supported by the 'Hong Kong approach to corporate difficulties' ('Hong Kong Approach') issued jointly by the Hong Kong Monetary Authority and the Hong Kong Association of Banks. This 'sets out formal but non-statutory guidelines on how banks should deal with corporate borrowers who are in financial difficulties and the way in which corporate workouts should be handled by banks.'[25] Similar guidelines exist in Thailand.[26] Even jurisdictions such as Japan, which have sophisticated statutory corporate rescue mechanisms, reveal a traditional preference for resorting to private non-statutory mechanisms,[27] a preference that is consistent with the realities in most other jurisdictions.

Second, it is important to acknowledge the role of governments and the impact of government policy, since all governments assume an indirect role in terms of formulating policy to support sectors that encounter economic difficulties and operating the macro-economic levers. In this regard, the focus of this article is on the degree to which governments play a direct role in relation to the corporate rescue of *individual* companies and the extent to which this role conflicts with, or is supported (and maybe even mandated) by, the written law. As this article will show, an example of the latter is mainland China, where the courts accept that decisions and arrangements in relation to corporate rescue must take account of the views of local governments.

Third, it is important to consider the treatment of foreign creditors and the extent to which the powers of foreign insolvency administrators and foreign insolvency proceedings are recognised and supported in practice. This is an important indicator of the degree of local protectionism and the willingness of jurisdictions to move away from the territorial approach towards the universal

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23 *PRC Enterprise Bankruptcy Law* art 75.

24 For Vietnam, see the *ADB Guide*, above n 20, 174. For the Philippines, see the *ADB Guide*, above n 20, 136.

25 These were revised in 1999: see, Hong Kong Monetary Authority, *Hong Kong Approach to Corporate Difficulties* <http://www.info.gov.hk/hkma/eng/public/qb9911/fa03.pdf>.

26 See, Bank of Thailand, *Framework for Corporate Debt Restructuring in Thailand* <http://www.bot.or.th/English/AboutBOT/related/CDRAC/privilege_list/Pages/BangkokFrameWork.aspx>. A similar approach was adopted in Indonesia between 1998 and 2003, where the Jakarta Initiative Task Force mediated in debt restructuring negotiations using the London Approach. See the *ADB Guide*, above n 20, 81.

27 See Stacey Steele, 'Insolvency Law in Japan' in Roman Tomasic (ed), *Insolvency Law in East Asia* (Ashgate, 2006) 13, 26.

approach in cross-border insolvency proceedings.[28] In some jurisdictions such as mainland China, the challenges in relation to foreign creditors continue to bedevil corporate rescue proceedings. As noted above, these challenges do not apply just in relation to the recognition and participation of cross-border insolvency proceedings; they also apply in relation to the participation of foreign creditors in domestic insolvency proceedings. In most (if not all) jurisdictions, the written law itself does not discriminate against foreign creditors in favour of local creditors; instead, it is in the implementation of law and the exercise of discretion by courts that foreign creditors are often prejudiced. The equal treatment principle is still vulnerable in practice.

To date, the countries that have adopted comprehensive laws on cross-border insolvency proceedings still constitute a minority. Only Japan and Korea have enacted laws along the lines of the United Nations Commission on International Trade Law ('UNCITRAL') *Model Law on Cross-Border Insolvency*, with encouraging results to date.[29] The absence of laws on cross-border insolvency is unfortunate as it seriously limits the effectiveness of corporate rescue and the ease with which multinational companies in financial distress can be restructured.[30]

On a positive note, the importance of corporate rescue is now widely accepted in Asia and most jurisdictions have formal, statutory-based corporate rescue mechanisms. Malaysia and Hong Kong stand out as two significant jurisdictions that do not yet have formal corporate rescue mechanisms that operate outside the context of winding-up or liquidation proceedings.[31]

III The Practical Realities of Corporate Rescue in Cross-Border Insolvencies — the APP and *Re Legend* Cases

As noted above, the absence of cross-border insolvency laws in many Asian jurisdictions limits the effectiveness of corporate rescue and the ease with which it can be utilised. The following cases highlight the significant challenges that still exist in this regard, particularly where the main operating assets of debtors are located in jurisdictions that do not have laws on cross-border insolvency and are consequently less likely to recognise offshore insolvency proceedings and administrators.

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28 For a definition of each of these approaches, see Australian Treasury, 'Approaches to cross-border insolvency' <http://www.treasury.gov.au/documents/448/HTML/docshell.asp?URL=6Approaches.asp>: 'The *universal* approach assumes that one insolvency proceeding will be universally recognised by the jurisdictions in which the entity has assets or carries on business...The *territorial* approach assumes that each country will have exclusive jurisdiction over the insolvency of a particular debtor and that separate proceedings for each country under that [country's] laws will be undertaken.'

29 See, for example, the cross-border proceedings in Australia, the UK and the US in relation to the restructuring of Samsun Logix Corporation in South Korea. In 2008 Australia enacted the *Cross-Border Insolvency Act 2008 (Cth)*, a law on cross-border insolvency on the basis of the *Model Law on Cross-Border Insolvency of the United Nations Commission on International Trade Law*, GA Res 52/158, UNGAOR, 52nd sess, UN Doc A/RES/52/158 (30 January 1998).

30 For calls for regional cooperation in this regard, see Richard Fisher and Michael Sloan, 'Why Asia needs a regional insolvency pact' [2004] *International Financial Law Review* 44.

31 See Part IV (A) in relation to Hong Kong.

The cases also demonstrate that if jurisdictions give creditors the right to initiate corporate rescue procedures, it is necessary to have statutory criteria to determine when the right is exercisable and this will inevitably require some discretion on the part of the courts. Even where creditors have the right to initiate corporate rescue procedures, courts may be reluctant to exercise their discretion in favour of creditors if the corporate rescue is unlikely to be recognised or have any material effect in the main operating jurisdiction. This reality continues to create challenges in Asia as the cases below demonstrate.

A *APP*

At the time of the legal proceedings in Singapore, the APP Group was one of the world's largest producers of pulp and paper products. Although incorporated in Singapore and listed in the US, APP's main operating assets were located in Indonesia and mainland China.[32]

In 2001, APP unilaterally announced a moratorium on the payment of its debts, triggering the largest debt restructuring in Asian history. Following this, APP proceeded to negotiate a consensual debt restructuring with its creditors. This involved the appointment of financial and legal advisors by APP and the establishment by creditors of a number of steering committees to protect their interests. In turn, these committees were advised by financial and legal advisors appointed by the creditors.[33]

In Indonesia, the government became directly involved in APP's debt restructuring through its agency, the Indonesian Bank Restructuring Agency ('IBRA'). IBRA's involvement came about after it took control of APP's largest creditor in Indonesia, PT Bank Internasional Indonesia, which had encountered financial difficulties and had granted IBRA security over the assets of APP's Indonesian subsidiaries in return for financial support.[34]

Prompted by dissatisfaction over the restructuring process, including concerns about the apparent lack of effort on the part of APP management and the inability of the independent auditor, KPMG, to gain access to information concerning the Chinese operations,[35] two APP creditors[36] filed a petition in the Singapore High Court for APP to be placed under judicial management.

The power to order judicial management is found in s 227(B) of the *Companies Act* (Singapore, cap 50), which provides that:

> The Court may make a judicial management order in relation to the company if, and only if, —

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32 For background information, see *Deutsche Bank AG & Another v Asia Pulp & Paper Company Ltd* [2002] SGHC 257 [2] to [12] and *Deutsche Bank AG and another v Asia Pulp & Paper Co Ltd* [2003] SGCA 19 ('*APP*') [2] to [12].

33 The writer acted for the steering committee established by the Chinese banks.

34 *Deutsche Bank AG and another v Asia Pulp & Paper Co Ltd* [2003] SGCA 19 [10].

35 Ibid [11].

36 Deutsche Bank AG and BNP Paribas.

> (a) it is satisfied that the company is or will be unable to pay its debts; and
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> (b) it considers that the making of the order would be likely to achieve one or more of the following purposes, namely:
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> (i) the survival of the company, or the whole or part of its undertaking as a going concern;
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> (ii) the approval under section 210 of a compromise or arrangements between the company and any such persons as are mentioned in that section;
>
> (iii) a more advantageous realization of the company's assets would be effected than on a winding up.

The above provision requires the court to exercise its discretion after taking a number of factors into account. In effect, the court has to be satisfied that a judicial management order would facilitate at least one of three objectives: (1) the rehabilitation of the company; (2) the preservation of its business as a going concern; and (3) a result that would better serve the interests of creditors than a winding-up.[37]

As noted by the Court of Appeal, the circumstances in which the creditors filed the petition were somewhat unusual. Unlike the situation where judicial management is initiated by an insolvent company to stave off a winding-up application by creditors, the creditors initiated the application for judicial management for the purpose of replacing the existing APP management.[38]

The decision of the High Court to refuse the creditors' petition was appealed to the Court of Appeal in Singapore, which dismissed the appeal and upheld the decision of the trial judge (Lai Siu Chiu J).

The Court of Appeal considered the arguments for and against judicial management[39] and decided not to interfere with the trial judge's exercise of discretion to refuse the application. Among the factors that the Court of Appeal identified as being relevant to the trial judge's decision were the role of IBRA in spearheading the consensual restructuring of APP's debts,[40] and the opposition of IBRA and the Chinese creditors to the petition.[41]

A significant factor in the decision of the trial judge to refuse the petition was the fact that 'there was no overwhelming support for or against the making of

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37 See *Companies Act* (Singapore, cap 50) s 227A, which outlines the circumstances in which a company or its creditors may make application for judicial management.

38 *Deutsche Bank AG and another v Asia Pulp & Paper Co Ltd* [2003] SGCA 19 [16].

39 Ibid [18] to [30]. One of the arguments raised by APP against a judicial management order was that APP's survival depended on money upstreamed from its subsidiaries in Indonesia and China. Because the main creditors of APP's subsidiaries, namely IBRA and the Chinese banks, were secured creditors, they had the power to 'ring-fence' their security to stop any payments upstream to APP. According to APP, if this occurred, 'the company would be forced to wind-up and its creditors would be worse off': [27].

40 Ibid [32].

41 Ibid [34]. See also *Deutsche Bank AG & Another v Asia Pulp & Paper Company Ltd* [2002] SGHC 257 [30], [31] and [58].

a judicial management order' and that 'it would be a pity to scuttle IBRA's efforts…to restructure the group's debts by consensus'.[42] The trial judge also noted that 'appointing judicial managers at this stage would only add another layer to the costs to be borne by APP and its subsidiaries' and that '[s]uch expenditure could be saved for payment to creditors'.[43]

In particular, the trial judge noted that although the judicial managers to be appointed intended to work in tandem with IBRA and with the Chinese creditors, it was unlikely that IBRA and the Chinese creditors would be willing to co-operate with the judicial managers. As noted by the trial judge, '[w]ithout the co-operation of IBRA and the [Chinese banks], the judicial managers would not be able to make any headway in the discharge of their duties outside Singapore.'[44] The trial judge noted the argument of APP that if judicial managers were appointed, they

> would encounter legal and practical issues in taking control of the boards and management of the operating subsidiaries in both Indonesia and China. Their attempts to do so may aggravate existing delays not to mention incurring additional costs at the company's expense, which could have been better utilised for the benefit of creditors.[45]

During the trial, an interesting argument raised by the petitioners, and referred to by counsel for APP as the 'Singapore card' argument, was that Singapore courts should grant redress to its creditors as APP was a Singapore company. The trial judge agreed, however, with the views of APP's counsel that the creditors of APP knew the risks involved in lending to APP and its subsidiaries and they 'should not now be heard to complain to a Singapore court suggesting otherwise.'[46] The lesson to be drawn from this is that creditors who lend to companies with assets in foreign jurisdictions should not expect the home jurisdiction to grant relief purely on the basis that the companies are incorporated in the home jurisdiction, particularly if they are sophisticated investors and should have been aware of the risks involved.

The decision in *APP* highlights the difficulties that creditors face when they attempt to initiate formal corporate rescue mechanisms in circumstances involving assets and operations in jurisdictions that do not have developed laws on cross-border insolvency. In particular, it highlights the extent to which courts need to take account of the practical realities, whether legal or otherwise, when considering a creditor-initiated corporate rescue process. In *APP*, the difficulties were compounded by the involvement of the Indonesian government through IBRA and the extent of control that secured creditors exercised over APP's operating assets in Indonesia and mainland China.

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42 *Deutsche Bank AG & Another v Asia Pulp & Paper Company Ltd* [2002] SGHC 257 [61].
43 Ibid [63].
44 *Deutsche Bank AG and another v Asia Pulp & Paper Co Ltd* [2003] SGCA 19 [34].
45 *Deutsche Bank AG & Another v Asia Pulp & Paper Company Ltd* [2002] SGHC 257 [30], [31] and [58].
46 Ibid [59].

B *Re Legend*

As with *APP*, this case highlights the practical difficulties in cross-border insolvency cases, particularly where there is no provision — either in law or in practice — for the jurisdiction in which the debtor company has its main operating assets to recognise and give effect to the foreign corporate rescue proceedings. An additional difficulty arose from the absence in Hong Kong of an effective corporate rescue mechanism outside the context of winding-up proceedings.

Legend International Resorts Ltd was a Hong Kong company whose business consisted of the operation of a casino in the Philippines. In 1998, the company ran into financial difficulties and defaulted in the repayment of debt to its creditors, resulting in the service of a written demand for payment of amounts owing under a syndicated loan.[47]

Subsequent attempts to restructure Legend's debts proved unsuccessful. On 3 November 2004, Morgan Stanley Emerging Markets Inc, which had acquired the debt previously owed to one of the lenders under the syndicated loan, filed a petition in the Hong Kong High Court for an order winding up the company and appointing provisional liquidators.

The power to appoint liquidators is contained in s 192 of the *Companies Ordinance* (Hong Kong, cap 32), which provides as follows:

> For the purpose of conducting the proceedings in winding up a company and performing such duties in reference thereto as the court may impose, the court may appoint a liquidator or liquidators, provisionally or otherwise, in accordance with sections 193 and 194.[48]

It is relevant to note that two days after the petition for the appointment of a provisional liquidator was presented, the company filed a petition in the local courts in the Philippines for corporate rehabilitation.[49]

The petition was opposed by Legend's management. At first instance, the judge (Kwan J) dismissed Legend's application to strike out the winding-up petition but refused to appoint provisional liquidators.[50] Morgan Stanley appealed to the Court of Appeal.

As noted by Hon Rogers VP on appeal, the basis on which the creditors applied for the appointment of provisional liquidators was that 'they should be empowered to explore a restructuring scheme for the company' and that 'it was not

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47 For background details, see *Re Legend International Resorts Ltd* [2006] HKCA 67 [3] to [16].

48 Ibid [25] and [26].

49 Ibid [11]. Although not alluded to in the judgment, the defensive nature of this action by the company and the possibility that it was taken in order to thwart the efforts of the creditors should not be overlooked.

50 A winding-up order was subsequently made. See *Re Legend International Resorts Ltd (No 2)* [2006] 3 HKLRD 270; *Re Legend International Resorts Ltd (No 3)* [2006] 3 HKLRD 289 and *Re Legend International Resorts Ltd* [2006] HKEC 2157 (winding-up order upheld on appeal).

in the best interests of the creditors that the restructuring process should remain in the hands of the then current management.'[51]

In other words, the primary purpose behind the creditors' application to appoint provisional liquidators was to explore, formulate and pursue a corporate rescue.[52] In this regard, there are some interesting parallels with *APP*, where the action by the creditors was also motivated by dissatisfaction towards the management and its efforts in the consensual debt restructuring process.[53]

In rejecting the appeal, Hon Rogers VP noted that under the relevant provisions in the Hong Kong *Companies Ordinance*, the primary purpose of appointing a provisional liquidator was to protect the assets of a company in the context of a winding-up and not for the purpose of restructuring the company and avoiding a winding-up.[54] As a result, the appointment of a provisional liquidator must be for the purpose of a winding-up.[55] Although it was possible for the provisional liquidators to be granted powers to facilitate a restructuring of the company once the grounds for the appointment of provisional liquidators had been established (e.g. a determination that the assets were in jeopardy), 'the court should not attempt to extend the statutory law albeit for expediency.'[56]

Further, Hon Rogers VP noted that the trial judge had come to the conclusion that the assets of the Company were not in jeopardy and that it would not be appropriate to appoint provisional liquidators in the circumstances, particularly in the light of the proceedings then being undertaken in the Philippines.[57]

Significantly, Hon Rogers VP acknowledged that even it had been established that the assets of the Company were in jeopardy, 'it would be necessary for the court to consider whether the appointment of provisional liquidators would serve any useful purpose.' This was uncertain in view of doubts as to what effective steps the provisional liquidators could take and whether the rights of the creditors would be recognised by the rehabilitation receiver in the Philippines:

> If the appointment of provisional liquidators cannot be shown to be likely to achieve any beneficial effect as regards the preservation of the assets of the Company the purpose of appointing provisional liquidators becomes problematic.[58]

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51 *Re Legend International Resorts Ltd* [2006] HKCA 67 [13].

52 Ibid [16].

53 Ibid [7]. The consensual debt restructuring commenced in 2000 in Malaysia, when the majority shareholder of Legend, a company called Metroplex Berhad, attempted to resolve its financial difficulties through a scheme of arrangement. Metroplex owed Legend a significant amount of money. This attempt failed, since a majority of creditors did not support the scheme.

54 Ibid [36].

55 Ibid [35].

56 Ibid [33]. The court noted the recommendations for the introduction of a law on corporate rescue under the *Report on Corporate Rescue and Insolvent Trading by the Law Reform Commission of Hong Kong* published in October 1996 and stated that it would not be appropriate for the court to examine the reasons why the law had not been introduced.

57 Ibid [42].

58 Ibid [49]–[50].

Like the decision in *APP*, the decision in *Re Legend* highlights the legal and practical obstacles facing corporate rescue in a cross-border context, particularly where the corporate rescue proceeding is creditor-initiated, the petition is opposed by management and the main operating assets are located in a jurisdiction that does not recognise cross-border insolvency proceedings.

The two cases also throw light on the possible ways in which debtor companies can use restructuring efforts and proceedings in other jurisdictions to circumvent proceedings by creditors in the jurisdiction of incorporation, and also on the extent to which government action in the foreign jurisdiction can interfere with the normal progress of corporate rescue proceedings, a theme that is explored further in Part V below.

IV Hong Kong and the Proposed Introduction of a Corporate Rescue Procedure

Proposals to introduce a formal corporate rescue procedure in Hong Kong are not new. Ten years ago, in 2001, legislative reform was recommended, but the proposal did not get off the ground as a result of perceived flaws in relation to certain issues including the treatment of employees, exclusion of shareholders from the provisional supervision process and difficulties in classifying creditors.[59] The turmoil arising out of the global financial crisis precipitated new calls for the introduction of a formal corporate rescue procedure. Following a period of consultation between October 2009 and January 2010, which commenced with the publication of a consultation paper (the 'Consultation Paper'), the Hong Kong government published its conclusions (the 'Consultation Conclusions') and announced that it would proceed to prepare the draft corporate rescue legislation.[60]

Many aspects of the proposed legislation have been vigorously contested, both in submissions in response to the Consultation Paper and in the public debate generally. The following two points are relevant to the analysis in this article and are considered below: (1) whether creditors should have the right to initiate the proposed corporate rescue procedure, known as 'provisional supervision'; and (2) whether Hong Kong should adopt a DIP system. These points are relevant because of the light that they throw on two of the legal indicators identified above; namely,

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[59] See Charles D Booth and Trevor N Lain, 'Rescuing Hong Kong Companies with Provisional Supervision: Proposals That Workers and Management Can Support' (2010) 40 *Hong Kong Law Journal* 271, 272; John K S Ho and Raymond S Y Chan, 'Is Debtor-in-Possession Viable in Hong Kong?' (2010) 39 *Common Law World Review* 204.

[60] See, Government of Hong Kong Special Administrative Region Financial Services and Treasury Bureau, *Procedure Legislative Proposals — Consultation Paper*, <http://www.fstb.gov.hk/fsb/ppr/consult/review_crplp.htm>. The proposed form of corporate rescue is to be based on the framework in the Companies (Corporate Rescue) Bill (Hong Kong) 2001, which would result in the enactment of a new ordinance to sit alongside the *Companies Ordinance* (Hong Kong) cap 32. As at the date of writing, the new Bill had not yet been released.

the degree to which creditors may initiate corporate rescue and the degree to which management should have a formal role in corporate rescue.[61]

A *Current Deficiencies and Proposed Solution*

At present, a company in Hong Kong that finds itself in financial difficulty has recourse to three options: (1) a private workout in accordance with the Hong Kong Approach;[62] (2) a scheme of arrangement under s 166 of the *Companies Ordinance*; and (3) provisional liquidation under ss 192–194 of the *Companies Ordinance*.[63]

Each of these options is considered to have its deficiencies. In relation to private workouts, the Consultation Paper noted that '[a]lthough the Hong Kong Approach has generally been well received, it only applies to banks and not other creditors and its successful implementation depends entirely on voluntary cooperation.'[64] In relation to a scheme of arrangement, the Consultation Paper noted as follows:

> The major deficiency of section 166 is the lack of a moratorium which can bind creditors while an arrangement plan is being formulated. As the process can be disrupted at any time if a creditor decides to petition for the company to be wound up, the lack of a moratorium creates uncertainty. There have also been complaints that schemes of arrangement are complex and require too much court involvement.[65]

In relation to provisional liquidation, the Consultation Paper noted that although courts had shown some flexibility in allowing provisional liquidation to facilitate corporate rescue, the use of provisional liquidation had been limited as a result of the decision in *Re Legend*, in which

> the Court of Appeal held that, in principle, provisional liquidators should not be appointed solely for the purpose of enabling a corporate rescue to take place and that the appointment of provisional liquidators should be on the basis that the company was insolvent and the company's assets were in jeopardy.[66]

In short, the Consultation Paper acknowledged the deficiencies of the current arrangements and the need to look at a new corporate rescue procedure.

The new procedure of 'provisional supervision' would involve the appointment of a third-party provisional supervisor, who would be responsible for preparing a 'voluntary arrangement' of the company's debts.[67] The procedure would trigger

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61 This paper does not consider other points that have been the subject of debate, such as employee protection and the insolvent trading provisions.

62 Hong Kong Monetary Authority, above n 25.

63 See III B above.

64 Government of Hong Kong Special Administrative Region Financial Services and Treasury Bureau, above n 60, [1.2].

65 Ibid [1.3].

66 Ibid [1.4].

67 See Government of Hong Kong Special Administrative Region, 'Government publishes consultation conclusions on corporate rescue procedure' (Media Release, 9 July 2010) <http://www.info.gov.hk/gia/general/201007/09/P201007090180.htm>:

a moratorium of 45 working days from the commencement of provisional supervision, which could be extended for up to six months by creditors, with an extension thereafter at the court's discretion. Other aspects of the procedure include a phased payment schedule for outstanding employees' entitlements and personal liabilities on directors for the debts of the company if they cause the company to trade while insolvent. This, it is said, would 'encourage distressed companies to act on insolvency earlier.'[68]

B Should Creditors Have the Right to Initiate Provisional Supervision?

Many of the submissions in response to the Consultation Paper argued in favour of allowing creditors to initiate provisional supervision.[69] Some of these acknowledged that certain threshold requirements would need to be satisfied before creditors could initiate the process and that creditors should obtain the sanction of the court in order to avoid unintended consequences, such as an abuse of process.[70] A relevant point raised in favour of the proposal to allow creditors to initiate the process was that this would help Hong Kong to maintain its regional competitiveness, particularly relative to mainland China. According to one submission:

> It is also paramount to ensure that Hong Kong has equivalent legislation to China (even though the Chinese legislation is debtor oriented and the proposed Hong Kong legislation is creditor oriented) given the strong ties between the two and the number of financially distressed companies and groups that have exposure to both Hong Kong and China.[71]

The Hong Kong Association of Banks ('HKAB') also argued in favour of allowing creditors to initiate provisional supervision, suggesting that this would encourage the early use of the procedure by debtor companies.[72] However, the

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> [t]he aim of introducing the corporate rescue procedure is to provide a statutory 'grace period' — a moratorium on civil legal action — for companies with long-term viability but facing short-term financial difficulty, so that they can restructure their business or debts, or seek capital injection to turn themselves around.

68 Ibid.

69 For access to the submissions, see Government of Hong Kong Special Administrative Region Financial Services and Treasury Bureau, 'Publications and Press Releases – Consultation Paper on the Review of Corporate Rescue Procedure Proposals Submissions' <http://www.fstb.gov.hk/fsb/ppr/consult/review_crplp.htm>.

70 See, eg, Deloitte Touche Tomatsu, Submission to Corporate Rescue Procedure Legislative Proposals, 28 January 2010 and PriceWaterhouseCoopers, Submission to Corporate Rescue Procedure Legislative Proposals, 29 January 2010). It is likely that the sanction of the court would require an exercise of discretion along similar lines to the statutory provisions in Singapore. See above Part III (A).

71 Ferrier Hodgson Limited, Submission to Corporate Rescue Procedure Legislative Proposals, 15 January 2010. See also Allen & Overy, Submission to Corporate Rescue Procedure Legislative Proposals, 28 January 2010.

72 The HKAB suggested that one of the lessons to be learned from the experience of the 1997 Asian financial crisis was that

> in most Asian jurisdictions which have enacted corporate rescue mechanisms over the last decade, with a few limited exceptions (for example Japan), there has not been a dramatic take-

proposal to allow creditors to initiate the proposal was rejected in the Consultation Conclusions. One of the main reasons given for rejecting the proposal was that 'for the most part, creditors would not have sufficient knowledge of the financial position of a company to make a judgment on whether it was a candidate for provisional supervision.'[73]

Given that the majority of jurisdictions in Asia with statutory corporate rescue procedures allow creditors to initiate the process, the position in Hong Kong appears anomalous. The Consultation Conclusions do not provide further details as to why a creditor-initiated process was rejected. It is likely that it would have represented too radical a change from the prevailing consensus, under which corporate rescue is considered to be a voluntary process in which the cooperation of the debtor company is essential.

C *Should a DIP Model be Adopted?*

Several submissions strongly supported the adoption of a DIP approach. For example, although acknowledging that it would not be appropriate to adopt the US model in its entirety, the HKAB argued for the introduction of a hybrid approach in which a provisional supervisor would always be appointed, but would have the discretion (subject to obtaining the prior consent of independent creditors) to 'carve out pre-defined management tasks to the directors.' After noting that the *PRC Enterprise Bankruptcy Law* had adopted such a hybrid approach, the HKAB argued as follows:

> Allowing an adapted form of a debtor in possession approach would be useful for SMEs in general and especially for closely-held, family run SMEs. There are two significant reasons why a modified debtor in possession approach would be of benefit to SMEs: Firstly, in a family run company there is a great disincentive for a second- or third-generation manager to file for provisional supervision if it will immediately lead to the family member being removed from the running of the business; and second, in many closely-held companies it will be difficult for any restructuring proposal to ultimately prove effective without the support of management, because management's personal connections and relationships will be crucial to the long-term success of the company. [74]

A hybrid DIP approach was also supported in the submission by Professor Booth, who suggested safeguards to ensure that management would not use this approach to avoid or delay repayment of its obligations to creditors. In his submission, Professor Booth also noted the benefits of a DIP option for SMEs, arguing that it would 'create more symmetry with the corporate rescue procedures

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up rate in the use of these procedures. Hong Kong would most likely prefer to avoid this result and enact a procedure that will prove useful with respect to both large corporations and SMEs.

[73] Government of Hong Kong Special Administrative Region Financial Services and Treasury Bureau, above n 60, [2.3]. In its submission, PriceWaterhouseCoopers had countered this argument by noting that creditors were becoming more sophisticated and that '[l]arge creditors often engage independent professionals to assist them in conducting business reviews when they believe their exposure is reaching uncomfortably high levels.'

[74] Others, on the other hand, have pointed to the lack of dispersed ownership as one of the reasons why the DIP approach would not be practical for Hong Kong: Ho and Chan, above n 59.

recently enacted in mainland China, which would be helpful given the extent of cross-border operations of many Hong Kong based companies' and that it 'may enhance cross border co-operation in restructuring (especially with mainland China).'[75]

Ultimately, the suggestion to adopt a DIP approach was rejected in the Consultation Conclusions, which responded as follows:

> We observe that there are some merits in the hybrid approach, such as offering more choice for the company, and providing for the option of retaining management in a role which creditors can determine. However, we note that adopting the hybrid approach will mean a major change in the design of the corporate rescue procedure. This would complicate the legislative regime and require more research and consultation. As the introduction of a corporate rescue procedure is long overdue, we do not consider it as appropriate to pursue the hybrid approach at the present stage.[76]

Once again, the Consultation Conclusions rejected a reform that would have diverged significantly from practice in Hong Kong to date. The rejection is interesting in view of persuasive arguments that it would accommodate the needs of SMEs in Hong Kong and facilitate cross-border restructuring efforts in circumstances involving mainland China, an outcome that might help to overcome some of the practical challenges as outlined in Part V below.

V Mainland China, the Role of Government and the Taizinai Case

As noted above, mainland China is important to the analysis in this article because of its economic significance, its increasing involvement in cross-border insolvency proceedings and also because it operates as an example of a jurisdiction in which there is legal support for an active and direct role by local government in corporate rescue. It is also important in terms of presenting an alternative perspective on insolvency law and corporate rescue, one that has some internal logic and consistency even though it diverges significantly from the global mainstream.

This section consists of three parts: (1) a brief overview of corporate rescue in mainland China; (2) an outline of the role of government; and (3) an analysis of the Taizinai case.

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[75] For details of this view, see Booth and Lain, above n 59, 282.

[76] Government of Hong Kong Special Administrative Region Financial Services and Treasury Bureau, above n 60 [122]. The Consultation Conclusions also stated at [120] that '[p]roviding for "debtor in possession" would be a fundamental change, which we did not consider appropriate, as it would deviate from the consensus reached during the earlier legislative attempts.'

A *Overview of Corporate Rescue in Mainland China*

Under the *PRC Enterprise Bankruptcy Law*, two formal, court-supervised corporate rescue procedures are available: reorganisation and settlement.[77] In addition to making provision for these procedures, the law recognises that the debtor and its creditors may reach agreement through an informal workout outside the context of formal court proceedings.[78]

Reorganisation applies to all creditors, including secured creditors, and imposes a stay on enforcement action by secured creditors.[79] It may be initiated either by the debtor or by its creditors. Although a reorganisation is required to be supervised by the administrator, there is provision for the debtor to manage its assets and business itself in place of the administrator by application to a people's court.[80]

Settlement differs from a reorganisation in that it is initiated and managed exclusively by the debtor; it is not supervised by the administrator and does not bind secured creditors. Inspired by composition proceedings in civil law jurisdictions, it appears to be designed to operate as a faster and less costly alternative to restructuring, particularly in insolvencies where the support of secured creditors is either more readily available or less critical to the success of the rescue.[81]

Since the *PRC Enterprise Bankruptcy Law* came into effect, these procedures have been utilised in several high-profile cases, including Taizinai. It is interesting to note that despite an increase in bankruptcy filings in the wake of the global financial crisis,[82] practitioners have remarked on the extent to which the *PRC Enterprise Bankruptcy Law* has been underutilised.[83]

B *The Role of Government*

One of the objectives of the *PRC Enterprise Bankruptcy Law* is to 'protect the order of the socialist market economy.'[84] The underlying objectives extend to

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77 The English translations for these terms are not uniform. Reorganisation (*chongzheng*) is also translated as 'restructuring' and settlement (*hejie*) is also translated as 'reconciliation' or 'composition'.

78 *PRC Enterprise Bankruptcy Law* art 105.

79 *PRC Enterprise Bankruptcy Law* art 75. See Godwin, above n 7, for an analysis of the stay and the associated uncertainties.

80 *PRC Enterprise Bankruptcy Law* art 73.

81 Godwin, above n 7, 762.

82 See John J Rapisardi and Binghao Zhao, 'A Legal Analysis and Practical Application of the PRC Enterprise Bankruptcy Law' (2010) 11 *Business Law International* 49, 59.

83 See Richard C Pedone and Henry H Liu, *Recent Developments in Bankruptcy Law in China* (Thomson West-Aspatore Books, 2010) 2. There are several possible reasons for this, including the lack of practical experience in relation to the implementation of the *PRC Enterprise Bankruptcy Law* and also the preference to resolve problems outside the context of formal bankruptcy proceedings. See also Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds), *China's New Enterprise Bankruptcy Law* (Ashgate, 2010) 349.

84 *PRC Enterprise Bankruptcy Law* art 1.

preserving the 'common interest of society'[85] and 'guaranteeing the lawful interests of enterprise employees in accordance with the law.'[86]

Although not referred to explicitly in the *PRC Enterprise Bankruptcy Law*, the role of local governments in corporate rescue was formally recognised in an opinion issued by the Supreme People's Court in 2009.[87] The Opinion notes the importance of utilising the various procedures in the *PRC Enterprise Bankruptcy Law* to ensure the fair and orderly repayment of debts, allocate resources appropriately and rescue enterprises in financial difficulty.

The important role of government in corporate reorganisation is reflected in several paragraphs of the Opinion. For example courts must 'diligently cooperate with government',[88] 'strive for the government's support in sensitive bankruptcy cases…and strengthen communication and cooperation with relevant departments.'[89] In addition, courts may accord priority to employment arrangements and the repayment of any funds advanced by government to settle employment debts.[90]

Significantly, the Opinion provides that in the context of a major financial restructuring, which may involve the introduction of a new investor, 'the people's courts should consider involving the relevant departments and personnel, particularly in view of the fact that the current profession of administrators in China is not mature.'[91]

The role of local governments as confirmed in the Opinion has been acknowledged by the local courts. The following comments from representatives of the High People's Court of Guangdong Province are particularly insightful in this regard:

> In China, the position of the local government in corporate reorganisation is unique. Before a company enters reorganisation, it will usually need to undergo extensive negotiations and coordination and obtain the consent and support of the local government. Normally it is only where the local government believes that the company is worthy of rescue and serves a positive function in relation to the local economy that the court will initiate reorganisation procedures. Doing it this way is realistic and reasonable. This is because the local government, which has the responsibility for economic development, is in a better position than a court to undertake a complete assessment of the value that an enterprise facing bankruptcy has to the local economy and society. In addition, during the course of a reorganisation case, the progress is much smoother where the support of the local government is

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85 *PRC Enterprise Bankruptcy Law* art 5.

86 *PRC Enterprise Bankruptcy Law* art 6.

87 Supreme People's Court *Opinion on Certain Issues concerning the Correct Hearing of Enterprise Bankruptcy Cases in Order to Provide Judicial Safeguards for Protecting the Order of the Market Economy*, issued on 12 June 2009 ('Opinion'). Interestingly, whether inadvertently or otherwise, the title of the Opinion picks up the wording in art 1 of the *PRC Enterprise Bankruptcy Law*, but it does not refer to China's 'socialist' market economy.

88 Ibid [4].

89 Ibid [5]

90 Ibid.

91 Ibid [12].

> obtained. The related work includes identifying strategic investors, making arrangements in relation to employees, protecting social stability, waiving tax liabilities and even coordinating and negotiating with the creditors, all of which require the government to be involved and to harness a large amount of social resources.
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> …whether the support of the local government has been obtained is an important factor for the court when deciding whether to approve a reorganisation plan. Furthermore, the support of the local government provides a greater guarantee in relation to the implementation of the reorganisation plan.[92]

The nature and extent of the role that courts in China attribute to local governments would be unheard of in most other jurisdictions that have adopted comprehensive laws on insolvency and corporate rescue. The above comments highlight both the pivotal role that local governments are considered to perform and also the extent to which courts are expected to consider and defer to the efforts of local governments when determining whether to approve applications for reorganisation. Although this approach diverges significantly from the global mainstream approach, it is arguably consistent with the statutory objectives of insolvency as outlined above, including protecting the socialist market economy and preserving the common interest of society.[93] It is also consistent with the active role of local governments in encouraging and approving foreign investment projects, a theme that is reflected in the discussion concerning the Taizinai case study below.

C *The Taizinai Case*

Hunan Taizinai Group Co was established as a dairy business with its base in Hunan Province and subsidiaries in Hunan, Beijing, Hubei, Sichuan and Jiangsu.[94] Ownership was subsequently transferred to a Cayman Islands holding company as part of a restructuring in 2006, when 'Morgan Stanley, Goldman Sachs and private equity firm Actis Capital paid $73 million for a 31 percent stake in Cayman Islands-registered Taizinai in 2007, with Morgan Stanley providing $18 million, Goldman Sachs $15 million and Actis Capital $40 million'.[95] The balance was held by the Group's founder, Li Tuchun.[96] As a

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92 Wang Jianping and Zhang Dajun, '*lun zhongguo chongzheng jihua pizhun zhidu —- chongzheng jihua pizhun zhidu zai zhongguo fayuan de shijian yu fansi'* [An Analysis of the Approval System for Reorganisation Plans in China — The Reorganisation Plan Approval System in Practice and Reflections of Chinese Courts] (Paper presented at 2010 2nd East Asia Symposium on Business Restructuring & Insolvency Practice and Law, Beijing, 30–31 October 2010) s 2(1). The extract was translated by the writer.

93 In recent years, the requirement for courts to take account of the political priorities and the broader social context has become stronger, particularly in cases involving political sensitivities.

94 'Wall St backed Chinese dairy firm collapses', *China Daily* (online), 14 April 2010 <http://www.chinadaily.com.cn/business/2010-04/14/content_9728619.htm>. The Group was particularly famous for its probiotic yoghurt drinks.

95 Nie Peng, 'Taizinai says Deloitte never provided auditing report', *China Daily* (online), 6 May 2010 <http://www.chinadaily.com.cn/business/2010-05/06/content_9818688.htm>. The Cayman Islands holding company, China Taizinai (Cayman) Ltd was established to hold the operating subsidiaries in China.

result, Taizinai Group converted into a foreign-invested enterprise, a process that would have required local government approval.[97]

Taizinai subsequently embarked on an ambitious expansion plan with the support of debt financiers, including a RMB 500 million yuan syndicated loan from foreign and domestic banks.[98]

In August 2008, Taizinai ran into financial difficulties and defaulted under its loan facilities, resulting in the acceleration of its syndicated loan obligations by Citibank as agent bank.[99] Taizinai's problems had been exacerbated by the melamine scandal, which had engulfed the dairy industry in China by that time and resulted in employee unrest.[100] In response to Taizinai's need for emergency funding, the local government made arrangements in the same month for another local company to provide a RMB 30 million loan to Taizinai.[101] This appears to have been the first direct intervention by the local government in the problems surrounding Taizinai.

In October 2008, Li Tuchun transferred a 61.6 per cent shareholding in the Cayman Islands holding company to the investment banks, as required under the agreement entered into in 2006 with the foreign investors.[102] This agreement incorporated a valuation adjustment mechanism under which the investment banks had the right to acquire a larger number of shares if certain financial targets were not met.

It is unclear to what extent the offshore share transfer was a factor in the events that subsequently occurred in China. However, shortly after the share transfer in December 2008, an individual, Wen Dibo, was appointed by the Zhuzhou Party Secretary and Mayor as a 'white knight' to resolve Taizinai's problems.[103] In January 2009, as part of the rescue plan, the local Zhuzhou government established a new company, Gaoke Dairy, to lease the core assets of Taizinai, with the intention of using the lease payment from Gaoke to repay the creditors.[104] According to Chinese news reports, this action was intended to be a 'Lei Feng' model for the restructuring of financially distressed enterprises in

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96 See, 'Curdled Milk', *Asia Private Equity Review* (online), May 2010 <http://www.asiape.com/apergc/apergc_issues/apergc1005.html>.

97 Foreign investment in Chinese companies requires regulatory approvals. The approvals are generally issued at the local government level expect in the case of investments over a certain amount, which are required to be approved by the central government.

98 Cao Chang, '*taizinai pochan chongzheng neimu*' [Behind the Scenes of Taizinai's Bankruptcy Reorganisation] *China Economic Weekly* 54, 56; Ellen Sheng, 'China's Hunan Taizinai in Provisional Liquidation', *The Wall Street Journal* (online), 14 April 2010. <http://online.wsj.com/article/SB10001424052702304159304575183683927734358.html>.

99 Ren Guanjun, '*taizinai jiang bei qiang xing pochan — gaoke naiye zao zhiyi*' [Taizinai to be Forced into Bankruptcy] *Shangdao jiantan*, 25 September 2010, 29.

100 Taizinai was not directly implicated at the time. However, it was later reported in April 2010 that melamine had been discovered in its raw materials (milk powder), which seriously affected its production and profits at a time when a corporate rescue was being negotiated: Ren, above n 99, 30.

101 See Lan Yu, '*taizinai zhe ji shichang de san da* mingmen' [Three Sources of Vitality in Taizinai's Broken Market] *chuangxin* keji [Innovative Technology], October 2010, 48, 49; Cao, above n 98, 54.

102 Lan Yu, above n 101, 49.

103 Ibid.

104 Ren, above n 99, 29.

China.[105] In addition, the local government provided almost RMB 100 million yuan in debt financing to repay some of the creditors.[106]

Thereafter, parallel efforts were made to rescue Taizinai, with Gaoke managing the business and Li attempting to find investors and secure emergency funding.[107] In October 2009, it was reported that the local government had established a 'leadership team' to identify potential strategic investors.[108] The efforts to find a strategic investor were successful, with three firms being short-listed and a successful bidder being selected in December 2009.[109] However, Li refused to sign the agreement with the successful bidder and asked the local government for a further opportunity to secure finance to rescue the company. Li's attempts in this regard were unsuccessful and the local government decided to hand control of the company back to Gaoke.[110]

In April 2010, Citigroup successfully obtained a winding-up order in Cayman Islands, pursuant to which the Hong Kong accounting firm, Borrelli Walsh, was appointed as provisional liquidator. Taizinai's management in China refused to recognise this order, announcing that the Cayman Islands ruling had no legally binding effect in China.[111]

It was around this time that the tension between the local government and Li reached breaking point, as Gaoke signed agreements with Chinese investors for the sale of core assets and Li pursued his own attempts to retrieve control of the business from the government. In open defiance of the local government, Li convened meetings with distributors, during which he criticised the 'illegal operations of the government' and asked them to sign agreements with a new company that he had set up. According to reports, these actions threatened the credibility of the local government, leaving it with little choice but to take action to assert its authority. In June 2010, criminal proceedings were launched and Li was placed in detention under suspicion of unlawfully obtaining public funds.[112]

In July 2010, the local court decided that Taizinai would enter reorganisation proceedings and announced that Beijing Deheng Law Firm had been appointed through competitive bidding as the administrator. It is not clear who initiated the reorganisation process, but it appears to have occurred without any obstacles or delay.[113]

In September 2010, the Chengdu auction company that had been appointed in relation to the operations in Chengdu announced that the assets of Taizinai Chengdu would be publicly auctioned in October. In November Citigroup

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105 Ibid 30. Lei Feng was a model soldier in China who became a symbol of virtue in the 1960s and remains a powerful propaganda symbol to this date.
106 Cao, above n 98, 57.
107 Ibid 54.
108 Ibid.
109 Ibid.
110 Lan Yu, above n 101, 49.
111 Nie Peng, above n 95.
112 Cao, above n 98, 55–6.
113 Ibid 56. In the writer's view, a reasonable assumption is that the process was initiated by local creditors at the request of the local government.

successfully obtained a decision against Taizinai in a Beijing court under the loan agreement, followed by a reported announcement by Li that he would appeal the decision.[114]

A creditors' meeting was held in December 2010, at which the administrator announced that Taizinai had enormous debts.[115] In February 2011, it was reported that the administrator had informed journalists that eleven strategic investors, including Gaoke, had expressed interests in Taizinai's business and that a complete reorganisation plan could be presented to creditors as early as March 2011.[116] This was subsequently delayed as a result of the failure of the administrator and the creditors to reach agreement.[117] As at the time of writing, it had just been announced that three of the operating units within the reorganised Taizinai Group would be sold to two domestic investors subject to approval by creditors and also the Zhuzhou Intermediate People's Court.[118]

The dust is yet to settle over the reorganisation of Taizinai. However, there are three themes arising out of the developments to date that are relevant for our purposes. First, there is no doubt that the local government played an active and interventionist role in the efforts to rescue Taizinai. This can be seen in its initial decision to arrange emergency funding in August 2008, its attempts to find strategic investors to purchase the business and its ultimate action in detaining Li Tuchun. Although legitimate queries have been raised in relation to the lawfulness of the criminal proceedings against Taizinai's founder,[119] it is difficult to identify any specific illegality or impropriety on the part of the local government in relation to its other actions. In fact, on a superficial level at least, its actions in arranging emergency funding and identifying potential strategic investors appear to be consistent with the role of government as outlined in Part V (B) above. It is also consistent with the role initially performed by the local government in approving Taizinai's conversion into a foreign-invested enterprise, a role that arguably gave it political — if not legal — justification for its intervention. In addition, the argument that a legal basis exists for government intervention is strengthened by the Opinion and the *PRC Enterprise Bankruptcy Law*, a key objective of which is to 'protect the order of the socialist market economy' as stated in art 1 of the *PRC Enterprise Bankruptcy Law*. In the writer's view, it is in the area of enterprise

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[114] '*taizinai jiu bei pan changhuan huaqi 5 yi zhaiwu tiqi shangsu*' [Taizinai Appeals the Order to Repay the 500 million Citi Debt] *caijing wangyi* [Caijing] (online), 11 November 2010 <http://www.58law.com/Article/2010/201011/20101112081337_5854.html>. It was also reported that of the seven subsidiaries, four had entered bankruptcy proceedings, with the Chengdu subsidiary being auctioned in October 2010.

[115] 'Famed Yogurt Maker Announces Huge Debts', *Xinhua* (online), 4 December 2010 <http://english.cri.cn/6826/2010/12/04/1461s608537.htm>.

[116] Ye Bihua, '*taizinai li tuchun qin jiu chuxi zisha*' [The Uncle of Taizinai's Li Tuchun Last Night Commits Suicide] *sina chuangye shidai*, 15 February 2011 <http://tech.sina.com.cn/chuangye/ch/2011-02-15/14515178823.shtml>.

[117] He Shan 'Taizinai restructuring delayed', *China.org*, 17 March 2011 <http://www.china.org.cn/business/2011-03/17/content_22164243.htm>.

[118] Pang Qi, 'Sanyuan Foods buys into Taizinai Group', *Global Times* (online), 30 August 2011 <http://www.globaltimes.cn/DesktopModules/DnnForge%20-%20NewsArticles/Print.a..>. The commentaries suggest that there was government involvement in the deal.

[119] Ibid.

bankruptcy that the concept of the 'socialist market economy' is most clearly exemplified.

Second, the evidence suggests that the government intervention interrupted and sidelined the formal corporate rescue processes. Instead of being determinative, these processes appeared to assume an instrumental role as the local government decided when and how they should be utilised.

Third, the saga highlights the difficulties that foreign investors and creditors face when they seek to enforce their rights in China. For example, the timing of the local government's decision to establish Gaoke, coming on the heels of the offshore share transfer, suggests that the local government was concerned that foreign investors would assume control of Taizinai and that it took active steps to maintain its own control. It also highlights the problems facing cross-border insolvency proceedings outside China when foreign investors and creditors seek to have winding-up orders and administrators recognised in China. The available evidence suggests that the appointment of a provisional liquidator in the Cayman Islands had no material impact in China.

Fourth, the saga highlights the conflicts and tensions that can arise between the interests of the three primary stakeholders in corporate rescues in China; namely, the foreign investors and creditors, local management and the local government.[120]

VI Conclusion

This article has identified a general trend in Asia towards recognising the importance of laws governing corporate rescue. As seen in Hong Kong, there is a gradual move away from the traditional reliance on private workouts towards the utilisation of formal statutory-based procedures. Although this move is positive, the decisions in *APP* and *Re Legend* and the experience in the Taizinai case highlight the extent to which corporate rescue can be hamstrung by cross-border obstacles and, in the case of mainland China, by the active and direct role that local governments play in the process.

At the heart of all of these developments are ongoing philosophical differences over the objectives of insolvency law, the rights and powers of creditors and debtor companies in initiating and implementing corporate rescue and the interests of broader stakeholders, including the interests of governments in protecting employees and achieving economic stability.

This article has sought to demonstrate that although Asian jurisdictions are converging in terms of recognising the need to have effective corporate rescue procedures in place, there is still a high level of divergence between Asian jurisdictions in terms of the models that have been adopted and also the response of each jurisdiction to the three legal indicators outlined above. In relation to the first indicator — the degree to which creditors may initiate corporate rescue — the

[120] Interesting, the struggle by management against the local government may be a positive sign that government intervention, at least as it relates to private enterprises, is increasingly contested.

cases of *APP* and *Re Legend* highlight the ongoing practical difficulties in this regard, particularly in cross-border insolvency proceedings. These difficulties are also reflected in the reluctance to allow creditors to initiate the proposed corporate rescue procedure in Hong Kong, even though this appears anomalous when compared with the position in other jurisdictions, including mainland China. In relation to the second indicator — the degree to which management has a formal role in corporate rescue — the reform process in Hong Kong highlights the ongoing debate concerning the appropriateness of a DIP approach. It also reveals the growing calls for reform in Hong Kong to harmonise with mainland China and the increasing importance of mainland China to the region as a whole. In relation to the third indicator — the treatment of foreign investors and creditors — the Taizinai case highlights the continuing challenges in this regard and the difficulties that arise when jurisdictions lack a workable legislative framework for recognising and supporting cross-border insolvency proceedings.

Mainland China provides a particularly interesting case study in relation to corporate rescue. Unlike other jurisdictions in Asia, China has chosen its own model, free of external pressure in the form of IMF-driven reform. As a result, it has tailored the model to accommodate its own approach to corporate rescue, under which government performs a central role in coordinating the process and co-opting the support of the relevant participants, including domestic banks and other creditors.[121] Such an approach, however, continues to create challenges for foreign investors and foreign creditors. It also highlights the reality that although the move towards greater harmonisation and regional cooperation has obvious benefits, these benefits are still some way from being realised.

[121] Of course, this approach assumes that domestic banks and other creditors will continue to be willing participants in government-driven reorganisations. It will be interesting to see whether this assumption holds as the domestic players become more assertive and independent of government influence.