according to the *Decision on Amending the Company Law of the People's Republic of China* at the 18th session of the Standing Committee of the 10th National People's Congress on October 27, 2005);

(2) *Guarantee Law of the People's Republic of China* (adopted at the 14th session of the 8th National People's Congress on June 30, 1995 and became effective as of October 1, 1995);

(3) *Enterprise Bankruptcy Law of the People's Republic of China* (adopted at the 23rd session of the 10th National People's Congress on August 27, 2006 and became effective as of June 1, 2007);

(4) *Property Rights Law of the People's Republic of China* (adopted at the 5th session of the 10th National People's Congress on March 16, 2007 and became effective as of October 1, 2007);

(5) *Guiding Opinions on Lifting the Ban on Transfer of Inventory Shares of Listed Companies* (Announcement [2008] No 15 of China Securities Regulatory Commission, promulgated and implemented as of April 20, 2008).

¶1-001 Overview of stakeholders in corporate reorganization

The *Enterprise Bankruptcy Law*[1] *of the People's Republic of China* (*Bankruptcy Law*) introduces the concept of corporate reorganization to China's insolvency legal system, paralleling that of other countries while addressing China's rapid economic development. Generally, a distressed corporation may address its financial difficulties through three distinct means — reorganization, bankruptcy liquidation proceedings, or reconciliation. Among these three methods, reorganization involves the most complex practical issues and involves one of the most intricate legal systems in commercial law.

The primary purpose of reorganization is to coordinate and balance the interests of all stakeholders with a comprehensive plan. Stakeholders in a corporate reorganization principally include:

(1) Creditors;

(2) The debtor company;

(3) Shareholders;

(4) The management; and

(5) Strategic investors of the debtor company.[2]

The strategies that each of these stakeholders adopts in the reorganization proceeding may vary due to divergent interests. This chapter will provide a practical analysis of the roles and interests of these stakeholders in corporate reorganization.

1 The *Enterprise Bankruptcy Law* of *the People's Republic of China* was approved by the 23rd Session of the Standing Committee of the 10th National People's Congress of the People's Republic of China on August 27, 2006, and became effective as of June 1, 2007.

2 From a general point of view, enterprise reorganization also includes the government and judiciary.

Creditors

¶1-002 Status of creditors in reorganization

According to the legislative intent of the *Bankruptcy Law*, creditors are entitled to repayment priority whether in a bankruptcy or reorganization proceeding. Bankruptcy proceedings aim to provide equitable repayment in the event that the debtor no longer exists as a legal entity, and focuses on protecting the creditor. In contrast, the purpose of the reorganization proceeding is to save the debtor company and ensure that the stakeholders receive equitable repayment. To achieve this purpose, the *Bankruptcy Law* establishes a series of measures including mandatory court approval of a reorganization plan under certain conditions. At the same time, the law also ensures that the amount that creditors receive under a reorganization plan is not less than what they would receive in a bankruptcy proceeding.[3]

From a practical perspective, creditors are the driving force in reorganization.[4] The *Bankruptcy Law* empowers creditors to exercise their rights in launching reorganization and establishing an organizational structure. Creditors may assume a number of roles in reorganization in the discussions below.

¶1-003 Overview of roles of creditors in reorganization

Creditors participate in reorganization through the following ways:

(1) Initiating the reorganization proceeding;

(2) Responding to a reorganization proceeding initiated by the debtor company. Under this situation, creditors should consider the following issues when responding:

(a) Continuing to do business with the debtor company;

(b) Filing timely creditor claims;

(c) Exercising retrieval rights;

3 Article 87 of the *Bankruptcy Law*.

4 Certainly, false insolvencies which are intended to escape mounting debt are an exception.

(d) Participating in the creditors' meeting and becoming members of the creditors' committee.

¶1-004 Initiating the reorganization proceeding

The *Bankruptcy Law* aims to protect creditors

The *Bankruptcy Law*, both in its legislative intent and corresponding mechanisms, aims to protect creditors. In this respect, the PRC law differs from the U.S. law (Chapter 11 of the *US Bankruptcy Code*), which focuses on protecting the debtor through the "debtor in possession" (DIP) mechanism.

Under the *Bankruptcy Law*, creditors may file a petition in court for reorganizing the debtor company. Once the creditor initiates the reorganization proceeding, the debtor company's assets will be legally forbidden from being distributed to certain creditors before other creditors are repaid. Therefore, reorganization initiated by creditors is able to ensure equitable repayment to all creditors and strives to protect the interests of all creditors.

The *Bankruptcy Law* establishes favorable conditions under which reorganization may be initiated

Since most distressed companies chose to solve their debt crisis by declaring bankruptcy when the *Enterprise Bankruptcy Law of the People's Republic of China(Interim)*[5] (*1986 Bankruptcy Law*) was in effect, many companies in China were under the false impression that the reorganization proceeding may be initiated only when their assets are not sufficient to repay their debts. China's conception of reorganization is significantly different from that of companies in western countries, where businesses in financial difficulty that appear solvent often initiate the reorganization proceeding to protect themselves.

To encourage distressed Chinese companies to utilize reorganization proceeding to protect their interests, the *Bankruptcy Law* establishes favorable conditions under which reorganization may be initiated. For instance, the debtor company may petition for reorganization if it significantly lacks repayment ability, yet is not completely insolvent.[6] Such a rule allows a company to seek legal protection before its financial situation further deteriorates. The timing of initiating reorganization is crucial – the earlier the proceeding is reduces the "treatment" cost of the distressed company and improves the chance that the company will be "cured." Therefore, creditors should place a significant focus on when to initiate the reorganization proceeding.

The *Bankruptcy Law* also establishes favorable conditions for relevant parties to initiate a reorganization proceeding.

5 The *Enterprise Bankruptcy Law of the People's Republic of China(Interim)* (*1986 Bankruptcy Law*) was adopted on the 18th Session of the Standing Committee of the 6th National People's Congress on December 2, 1986 and became effective as of November 1, 1988.

6 Article 2 of the *Bankruptcy Law*.

(1) When the debtor company initiates the proceeding, it shall file in court a petition in writing with evidence, such as an asset statement, debt statement, statement of creditor's rights, relevant accounting reports, staffing plan, payrolls and proof of purchasing social insurance.[7]

(2) When creditors initiate the proceeding, they are required to file the petition for reorganization with evidence to prove that the debtor company is unable to pay off its debts as they become due.[8] The court will then approve the reorganization if it believes the company significantly lacks solvency.

Measures for protecting a debtor company's assets after initiation of reorganization proceeding

A debtor company's assets are protected by law after the reorganization proceeding is initiated. For example:

(1) The debtor company is prohibited from repaying only some, instead of all, creditors.

(2) The court may void certain transactions that the debtor company had executed on its assets prior to approving the petition.

(3) Execution of any transactions against the debtor company's assets shall be suspended.

(4) Asset preservation measures executed against the debtor company's assets shall be lifted.[9]

These protective measures provided by the *Bankruptcy Law* may prevent the loss of the debtor company's assets, further deterioration of the debtor company's financial status and secure the debtor company's repayment to creditors.

¶1-005 Continuing to do business with the debtor company

Pursuant to the *Bankruptcy Law*, the goal of reorganization is to revive the debtor company. The stakeholders first formulate a reorganization plan that helps the debtor company to continue its operational activities.

Moreover, the *Bankruptcy Law* establishes special rules that leave the decision of whether to perform unfulfilled contractual duties and continuing business operations to the debtor company.

When deciding whether to continue to do business with the debtor company, the creditors should take into account three types of issues:

7 Article 8 of the *Bankruptcy Law*.

8 Article 8 of the *Bankruptcy Law*.

9 Articles 16, 19, 31, 32 and 33 of the *Bankruptcy Law*.

First, whether their existing claims are secured and whether such claims would be regarded as unsecured claims or common liabilities.

Whether the existing creditors' rights can be secured is a chess match between the creditors and the debtor company (or the administrator). The creditors will hold considerable bargaining power if their contracts are indispensable to the debtor company.

Second, whether they should continue to perform under an existing contract with the debtor company or enter into a new one, taking into consideration whether the debtor company has the financial strength to repay existing creditors' claims if these claims are treated as common liabilities.

(1) When deciding whether to continue to perform under an existing contract with the debtor company or enter into a new one, creditors may have different approaches adopt the following steps according to the particular situation. As the administrator may decide at its discretion whether the debtor company should terminate or continue to perform under a contract, the liabilities arising from performance of a contract between the debtor company and creditors may be regarded as common liabilities could be paid in the normal course of business. Creditors may ask the administrator to provide security for the debtor company's repayment obligations; otherwise they may refuse to continue to perform under the contract.

(2) Likewise, where creditors need to enter into a new contract with the debtor company, they may require the administrator or the debtor company to provide security for the debtor company's performance.

Third, whether the debtor company's reorganization is successful, and if so, how would the debtor company's core business change according to the new operation plan, and likewise whether it would be realistic to continue as a long-term business partner of the debtor company.

Creditors may also vote at the creditors' meeting to decide whether the debtor company should continue its business operations or approve the debtor company's operation plan under the proposed reorganization plan.[10] This way, the *Bankruptcy Law* empowers the creditors to determine they should continue long-term business relationship with the debtor company.

If the reorganization initiated by creditors is unsuccessful, the debtor company will enter bankruptcy proceedings. Once the debtor company goes bankrupt, the opportunity cost to creditors will increase. Therefore, creditors should carefully weigh the costs and benefits of continuing to do business with the debtor company in reorganization.

10 Article 16 of the *Bankruptcy Law*.

¶1-006 Filing timely creditor claims

The *1986 Bankruptcy Law* provided that creditors are deemed to have waived their rights if they do not file their claims within the specified time limit.

To better protect creditors, the *Bankruptcy Law* establishes that creditors that do not file claims within the time limit specified by the People's Court may still file their claims before the final distribution of the bankruptcy estate. However, creditors that fail to file their claims by the distribution will not be entitled to any of the assets. Moreover, creditors must bear the costs of reviewing and confirming claims filed after the specified time limit.[11]

For these reasons, creditors should focus on filing claims on time together with sufficient evidence to facilitate the administrator's review of the claims. They may exercise their voting rights at the creditors' meeting and are entitled to distribution from the bankruptcy estate after the administrator approves their claims. However, if the creditors do not file their claims, they may face many uncertainties regarding the debtor company's implementation of the reorganization plan and the repayment of their claims.[12]

¶1-007 Exercising retrieval rights[13]

Retrieval right in bankruptcy law refers to a claim on an asset. An owner with valid retrieval rights may repossess the assets that the debtor company controls but does not own by making a request to the administrator.

If creditors wish to exercise their retrieval rights, they should do so when they file their claims, otherwise the claims will automatically be regarded as unsecured claims. The *Bankruptcy Law* provides that during the reorganization proceeding, creditors may request retrieval of their assets that are legitimately held by the debtor company when certain conditions are met.[14]

If the administrator does not approve a creditor's retrieval right on an asset, the creditors should consider filing an unsecured claim. Otherwise, the creditor may never be able to repossess the asset held by the debtor company and lose the opportunity to claim unsecured rights.

11 Article 56 of the *Bankruptcy Law*.

12 In previous reorganization cases, the reorganization plans adopted different approaches towards the creditors filing their claims within the given time limit and those that did not file their claims within the given time limit. Creditors who file their claims within the time limit may receive a certain number of shares as repayment. The debtor company may reserve some shares for the creditors who fail to file their claims within the time limit but these shares will only be kept in the administrator's account for a period of time. These creditors will never have the chance to receive these shares as repayment if they do not file their claims in the grace period.

13 The retrieval right refers to that the right of the owner of an asset to retrieve the asset that the debtor company does not own from the debtor company' assets managed or controlled by the administrator. The owner may exercise the retrieval right beyond the bankruptcy proceeding.

14 Article 76 of the *Bankruptcy Law*.

INVESTMENT OPPORTUNITIES IN COMPANIES UNDER REORGANIZATION

By Liu Yanling

The *Bankruptcy Law* is often associated with struggling companies that are barely able to meet their creditors' demands and turns a shareholder's worst nightmare into reality. However, the old adage that "in every crisis lies an opportunity" often holds true in the case of restructuring companies. The restructuring process not only cleanses a company of much of its burdensome debt, but also provides a revealing glimpse into the company's true balance sheet. Facing the threat to write off the entire claim against the company forces many creditors to "come out of the woodwork" to quantify their claims. This inevitably reduces the level of unforeseen risks for potential investors. Nevertheless, significant pitfalls remain for investors who wish to become stakeholders in restructuring companies. This chapter outlines both the benefits and risks of investing in a company undergoing restructuring in China.

¶3-000 Laws and regulations covered in this chapter

(1) *Enterprise Bankruptcy Law of the People's Republic of China* (adopted at the 23rd session of the 10th National People's Congress on August 27, 2006 and became effective as of June 1, 2007);

(2) *Rules for Tax Treatments During Corporate Restructuring* (promulgated by the State Administration of Taxation Decree No 6 on January 1, 2003 and became effective as of March 1, 2003);

(3) *Notice on Clarification of Issues Relating to Income Tax upon the Implementation of Enterprise Accounting System* (*Guoshuifa* [2003] No 45, promulgated by the State Administration of Taxation on April 24, 2003 and became effective as of January 1, 2003);

(4) *Administrative Rules for the Issuance of Securities by Listed Companies* (adopted on the 178th chairman working meeting on April 26, 2006 and promulgated by the China Securities Regulatory Committee Decree No 30 on May 6, 2006; amended according to the China Securities Regulatory Committee's *Decision on amendment of Several Rules of Cash Dividend by Listed Companies* on and became effective as of May 8, 2006);

(5) *Administrative Rules on the Takeover of Listed Companies* (adopted in the 180th chairman working meeting of China Securities Regulatory Commission on May 17, 2006, amended by the China Securities Regulatory Commission on August 27, 2008 and became effective as of September 1, 2006);

(6) *Administrative Rules for Material Assets Restructuring of Listed Companies* (adopted on the 224th chairman working meeting of the China Securities Regulatory Commission on March 24, 2008 and became effective as of May 18, 2008);

(7) *Supplementary Rules for the Pricing of Share Issuance during Material Assets Restructuring of Reorganizing Listed Companies* (adopted by the China Securities Regulatory Commission and became effective as of November 12, 2008);

(8) *Notice on Issues Relating to Treatment of Corporate Income Tax Arising from Corporate Restructuring* (*Caishui* [2009] No 59, promulgated by the Ministry of Finance and the State Administration of Tax on April 30, 2009 and became effective as of January 1, 2008).

¶3-001 Overview of corporate reorganization mechanism and investment opportunities in companies under reorganization

The *Enterprise Bankruptcy Law of the People's Republic of China* (*Bankruptcy Law*), effective as of June 1, 2007, establishes China's corporate reorganization mechanism. The promulgation of the *Bankruptcy Law* fills a gap in China's economic legislation and reflects the maturation of the country's economy and legal system.

Reorganization is a legal proceeding with the purpose of resuscitating an insolvent or financially distressed company with the intervention of the court. The reorganization system, which is an important component of the insolvency legislation of many jurisdictions, represents the mainstream development of international insolvency law.

In a competitive market, the players, especially large companies, have to cope with dynamic market conditions and many factors that may impact their business operations. Solvency is not the only criterion to determine the business value of a company. Liquidating a financially distressed company with operations and potential profit capacity does not conserve and improve the overall value of the company. The dissolution of a company is also likely to result in layoffs and the bankruptcy of more

companies, which is detrimental to social stability. The introduction of the reorganization mechanism plays an important role in helping distressed companies regain vitality while protecting the interests of all parties that the potential bankruptcy may have an impact on, including the company's creditors.

Meanwhile, the implementation of reorganization, which is also a means to optimize resource allocation, may involve activities that may create new investment opportunities, such as debt and assets restructuring, and mergers and acquisitions. Comparing investments in companies in reorganization with more traditional investment approaches, investments in reorganizing companies offer some advantages while also representing unique challenges for investors. The investors who are able to properly manage risks and correctly understand China's bankruptcy law and regulations are those equipped to achieve satisfying returns from participating in the reorganization proceeding.

The Importance of Investment Opportunities in Reorganization

¶3-002 The participation of investors in reorganization

Whether a company is listed or private, the company's investors are usually involved in a corporate reorganization. Most Chinese listed companies that reorganized under the *Bankruptcy Law* went through the process with the help of their investors.[1] These distressed companies either introduced new strategic investors or received additional capital investments from their existing shareholders.

1 As of December 31, 2010, 30 PRC listed companies have entered reorganization under the Bankruptcy Law. 27 of them have now completed reorganization. The 27 companies that have completed the bankruptcy reorganization process include: Hebei Baoshuo Co., Ltd., Caozhou Chemical Industrial Co., Ltd., Chengde Dixian Textile Co., Ltd., Lanbao Technology Information Co., Ltd., Shangdong Jiufa Edible Fungus Co., Ltd., Changling Group Co., Ltd., Zhejiang Haina Science and Technology Co., Ltd., Stellar Megaunion Co., Ltd., Zarva Technology Co., Ltd., Guangdong Hualong Groups Co., Ltd., Guangxi Beisheng Pharmaceutical Co., Ltd., Jiaozuo Xin'an Science and Technology Co., Ltd., Shanghai Worldbest Co., Ltd., Tianfa Petroleum Co., Ltd., Tianyi Science and Technology Co., Ltd., Beiya Industrial Group Co. Ltd., Suntek Technology Co., Ltd., Dandong Chemical Fiber Co., Ltd., Shanxi Qinling Cement (Group) Co., Ltd., Amoi Electronics Co., Ltd., Guangming Group Furniture Co., Ltd., Shenzhen Shenxintaifeng (Group) Co., Ltd., Xianyang Pianzhuan Co., Ltd., Jinhua Chemical Industry Group Chlor-Alkali Co., Ltd., Liaoyuan Deheng Co., Ltd., Guangdong Shengrun Group Co., Ltd. and Shanghai Huayuan Enterprise Development Co., Ltd. Guangxia (Yinchuan) Industrial Co., Ltd., Chuangzhi Information Technology Co., Ltd., and Sichuan Direction Photoelectricity Co., Ltd. are still being reorganized. King & Wood has served as legal counsel to 18 of these 30 companies.

¶3-003 The need for external financial support in reorganization

Many of the listed companies that reorganize under the *Bankruptcy Law* have serious financial difficulties or have an overwhelming amount of debt. In turn, they need sound external financial support to help them implement their reorganization plan. This external financial support covers companies' reorganization costs, helps repay their debts, and maintains or helps them return to their regular level of business operations.

Theoretically, a debtor should be able to complete reorganization and maintain its normal business operations without any external financial support, also known as "financial bootstrapping." Many of the companies that have completed reorganization have found it extremely difficult not to use external financial support, even though the *Bankruptcy Law* does not require them to seek external support. Moreover, since companies are attempting to increase their prospects for success in implementing a reorganization plan, the companies usually attempt to find a good partner to support them through the reorganization instead of trying to make it through on their own financial strength.

¶3-004 Distressed listed companies that need a complete consolidation need new investment

In general, many distressed listed companies not only have a debt crisis, but also face serious profitability problems. These profitability problems are often rooted in inactive assets, business operations problems, and basic corporate governance issues. All of these problems must be addressed for the company to be able to return to profitability. The ultimate solution for all of these problems is an overall company consolidation or restructuring. A company and its investors usually formulate the company's reorganization plan in accordance with its actual situation, and this plan sometimes renews the company's focus on its core business and sometimes restructures the company's assets and debts to maximize the company's chances for a return to profitability by making another aspect of the company its new core business.

¶3-005 The value of investing in reorganizing companies

In most cases, companies in distress are undervalued in the market, or their value in the market does not reflect their true or potential value for two specific reasons.

Firstly, the China Securities Regulatory Commission's (CSRC) approval for an initial public offering (IPO) is difficult to get, and many companies cannot get their "shell" listed on the stock exchanges so that they can recapitalize. Listing a shell is a convenient and inexpensive way for private companies to go public and reorganize with new capital, but IPO approval for a shell is very difficult to obtain. In addition, non-listed companies with government licenses to provide services like securities companies, trust companies, and financial leasing companies are other types of shell that provide a good basis to reorganize. However, reorganizing one of these types of companies requires the government's approval so that it will be able to keep its government-issued licenses after the reorganization.

Secondly, the causes of a company's financial distress and debt crisis vary on a case-by-case basis. Some companies that attempt to reorganize, especially non-listed companies, have good market potential or have a unique position in the market. For example, some manufacturing companies attempting to reorganize have their production interrupted because of a debt crisis, but their industrial resources, distribution channels, and market share are valuable if their debt can be restructured and consolidated.

Change in business after reorganization

Of the 27 listed companies that have completed reorganization, only a few of them have kept their core businesses intact, and most of the businesses restructured by focusing on one aspect of their business that was not their core business and shifted focus to other businesses. Many of these companies acquired new assets to assist this new core business' prospects for success. On the other hand, non-listed companies usually do not attempt to change their core business when they reorganize because they find it difficult to find additional financing for a new core business. This fact is especially true when they already have a potentially profitable core business.

Advantages of Investing in Reorganizing Companies

¶3-006 Overview

When investing in a listed company that is reorganizing is compared with other investment alternatives, investing in a listed company that is reorganizing has several advantages:

(1) Safety and transparency;
(2) Speed;
(3) Lower costs;
(4) Greater chance of success.

¶3-007 Safety and transparency

When an investor buys a company outside of the reorganization process, it can be difficult to get the target company to provide the investor with enough information about the target company's debt, and in turn, the investor faces increased potential costs and risks.

As part of the reorganization process the court and creditors require the reorganizing company to make complete and sufficient disclosure of all of its assets and liabilities. The *Bankruptcy Law* establishes that after a company begins the reorganization procedure, all of the company's creditors have a certain amount of time to declare what the reorganizing company owes them.[2] Creditors that fail to make a claim in the specified timeframe will not be paid as part of the reorganization plan, and they may only be repaid after the reorganization plan has been completely implemented.[3] Because investors that acquire a stake in a reorganizing company can review the company's debts and assets, the chances of the reorganizing company having a huge undisclosed debt are minimized.

In addition, once the court approves a reorganization plan it becomes legally binding on the reorganizing company, all of its creditors, and shareholders.[4] Investors in non-reorganizing companies do not necessarily gain the protection from the People's Courts when they try to implement the investment plan they work out with the target company. If they would like to guarantee the implementation of the plan, they will have to sue the target company and ask the court to force the company to specifically perform the plan. Alternatively, investors that acquire a stake in the reorganizing companies under the *Bankruptcy Law* already have the power of the People's Courts to support the implementation of the reorganization plan.

¶3-008 Speed

In a non-bankruptcy reorganization acquisition and restructuring, investors have to negotiate with each of the target's creditors to settle its debts. If the investor cannot quickly settle with the creditors, the negotiations for the acquisition may be unduly prolonged or even fail. However, the *Bankruptcy Law*'s creditor voting mechanism establishes that the company's reorganization plan will be adopted if a majority of the creditors within each voting group vote for the plan and the total number of creditors, within all voting groups, voting for the plan represent more than two-thirds of the total claims for payment against the company.[5] Even if a voting group votes against the plan, the court may still adopt the plan, so long as the conditions in Article 87 of the *Bankruptcy Law* are met.[6] Essentially, an entity investing in a reorganizing company will be able to substantially lower its acquisition and restructuring negotiating costs and shorten the time it takes to acquire or restructure a target.

Moreover, statistics show that the time needed for a listed company[7] to reorganize (from the day the court accepts a reorganization request, to the day the court approves the reorganization plan) is shorter than that the time a listed company needs to restructure its debt outside of bankruptcy.[8]

¶3-009 Lower costs

Article 85(2) of the *Bankruptcy Law* establishes that a company in reorganization may arrange for its existing shareholders to transfer cash or equity in the company to the company's creditors as a way to repay company debt.[9] This tactic allows investors and the company's creditors to acquire additional equity or shares in the company with less cash and helps the company with its liquidity problems.

Furthermore, Article 42 of the *Administrative Rules for Material Assets Restructuring of Listed Companies* (*Material Assets Restructuring Rules*) establishes that when a company plans to purchase assets or pay down debt by issuing additional stock, the newly issued stock's price should not be lower than the company's average stock price over the last 20 trading days prior to the board of directors meeting that passes the resolution for the assets purchase or debt repayment. Also, if investors intend to invest in a company that has been suspended from being listed, that company's share price may vary greatly and deviate from a reasonable price range on the secondary market and the price per share the investors pay will be based on the secondary market's pricing standards.

Moreover, according to the CSRC's *Supplementary Regulations on Pricing Listed Companies Share Issuances while the Company Undergoes a Material Assets*

2 Article 48(1) of the *Bankruptcy Law*.

3 Article 92(2) of the *Bankruptcy Law*.

4 Article 92(1) of the *Bankruptcy Law*.

5 Articles 84 and 86 of the *Bankruptcy Law*.

6 Article 87 of the *Bankruptcy Law* establishes that a debtor or the bankruptcy administrator may negotiate with a voting group when that voting group votes against the proposed reorganization plan. However, this negotiation should not impair the other groups' voting rights on the reorganization plan. After this negotiation, the group that voted against the plan may be asked to vote on the plan again, as long as six conditions are met:

(1) The reorganization plan must ensure that all creditor claims under Article 82(1)(1) of the *Bankruptcy Law* (secured property) are fully repaid, and any damages arising from delaying repayment of that debt is reasonably compensated. Moreover, the reorganization plan must ensure that no material damage has occurred to the dissenting voting group's secured claims unless such voting group approves of the reorganization plan.

(2) The reorganization plan must ensure that creditor claims made under Articles 82(1)(2) and 82(1)(3) are fully repaid or that the corresponding voting groups have passed the proposed reorganization plan.

(3) After the negotiation with the dissenting voting group, the reorganization plan still pays, at least the same amount of unsecured claims as it did before the additional negotiation took place. Or if it does not pay the unsecured creditors, the unsecured creditors approve of the reduced rate in the reorganization plan.

(4) The adjustments made to the reorganization plan after the negotiation are fair and equitable to the investors, or the investors voting group has passed the proposed plan.

(5) The newly negotiated reorganization plan treats the members of each voting group fairly, and the priority for creditor repayment adheres to Article 113.

(6) The reorganization plan is feasible for the debtor to implement.

If the People's Court approves of the terms of a reorganization plan, it should approve, terminate, and publically disclose the reorganization plan within 30 days after the application.

7 Statistics show that it took an average of 96.48 days for the 27 companies to complete reorganization. Theslowest reorganization was that of Guangming Group Furniture Co., Ltd., which took 270 days. Thequickest reorganization was that of Guangxi Beisheng Pharmaceutical Co., Ltd., which took only 32 days.

8 Statistics show that it usually takes less than 6 months for a listed company to settle its debts via reorganization, and some listed companies have even completed their reorganization in around 30 days.

9 Article 85(2) of the *Bankruptcy Law* provides that when a reorganization plan involves changes to the investors' interests, there must be an investor voting group established at the creditors' meeting to ensure that the investors approve of the changes to their interests.

TAXATION ISSUES IN CORPORATE REORGANIZATION

By Tony Dong and Wu Libin

Tax is an important factor in corporate reorganization and different approaches influence the tax burden of relevant parties and reorganized company in many ways. Adopting an optimum approach for tax burden is of momentous significance for reorganization proceedings and reorganized company to regain capacity. The current PRC law does not address tax treatments in reorganization, so a company should adhere to the tax treatment rules used for corporate restructuring. Currently, corporate reorganization has several approaches, such as equity restructuring, asset restructuring, merger, divestiture and debt restructuring, etc., which are also the approaches of corporate reorganization. Relevant parties shall assess the tax influence when choosing approaches.

¶9-000 Laws and regulations covered in this chapter

(1) *Taxation Administration Law of the People's Republic of China* (adopted at the 27th session of the Standing Committee of the 7th National People's Congress on September 4, 1992, amended according to the *Decision on Amending Taxation Administration Law of the People's Republic of China* at the 12th session of the Standing Committee of the 8th National People's Congress on February 28, 1995 and amended at the 21st session of the Standing Committee of the 9th National People's Congress on April 28, 2001);

(2) *Enterprise Bankruptcy Law of the People's Republic of China* (adopted at the 23rd session of the 10th National People's Congress on August 27, 2006 and became effective as of June 1, 2007);

(3) *Interim Regulations for Value-added Tax of the People's Republic of China* (Order No 134 of the State Council, promulgated on December 13, 1993,

amended at the 34th routine conference of the State Council on November 5, 2008 and became effective as of January 1, 2009);

(4) *Interim Regulations for Business Tax of the People's Republic of China* (Order No 136 of the State Council, promulgated on December 13, 1993, amended at the 34th routine conference of the State Council on November 5, 2008 and became effective as of January 1, 2009);

(5) *Implementing Rules for Taxation Administration Law of the People's Republic of China* (Order No 362 of the State Council, promulgated on September 7, 2002 and became effective as of October 15, 2002);

(6) *Notice on Issues Relating to Implementation of National Value-added Tax Transformation Reform* (*Caishui* [2008] No 170, promulgated by the Ministry of Finance and State Administration of Taxation on December 19, 2008 and became effective as of January 1, 2009);

(7) *Implementing Rules for the Interim Regulations on Value-added Tax of the People's Republic of China* (Order No 50 of the Ministry of Finance and State Administration of Taxation, promulgated on December 15, 2008 and became effective as of January 1, 2009);

(8) *Notice on Issues Relating to Treatment of Corporate Income Tax Arising from Corporate Restructuring* (*Caishui* [2009] No 59, promulgated on April 30, 2009 and became effective as of January 1, 2008);

(9) *Notice on Enterprise Income Tax Treatment for Companies into Liquidation* (*Caishui* [2009] No 60, promulgated on April 30, 2009 and became effective as of January 1, 2008);

(10) *Administrative Rules for Enterprise Income Tax for Corporate Restructuring* (Announcement No 4 of the State Taxation, promulgated on July 26, 2010 and became effective as of January 1, 2010);

(11) *Notice on Application of Low Value-added Tax Rate on Certain Goods and Streamlined Procedures for Levying Value-added Tax* (*Caishui* [2009] No 9, promulgated by the Ministry of Finance and the State Administration of Taxation on January 19, 2009 and became effective as of January 1, 2009).

¶9-001 Overview

Corporate reorganization refers to the legal procedure under which the debtor and creditors enter into a reorganization agreement and formulate a reorganization plan under the auspices of the court with a purpose to help the debtor out of financial distress and regain operating capability. Reorganization is a sole regime under the insolvency law and is often initiated by the creditors when the debtor's assets are insufficient to pay its debts or the debtor significantly lacks insolvency. Corporate reorganization was first introduced by the *Enterprise Bankruptcy Law of the People's Republic of China* (*Bankruptcy Law*) which became effective as of June 1, 2007.

Corporate reorganization is often the last resort for a financially distressed corporation which does not want to go bankrupt. In reorganization, a company utilizes legal proceedings to reorganize its debts, assets, equity, business, and staff to

resolve its financial difficulty. As reorganization continues, it will often trigger various tax issues involving transactions among its creditors, shareholders, and other interested parties.

However, reorganization is not an extension of taxation. The current PRC tax law regimes do not sufficiently address "reorganization" or the tax treatments for the involved parties. Instead, the tax implications underlying reorganization arrangement shall, in great extent, observe the tax treatment for corporate restructuring transactions, which refer to the restructuring activities taking place in the normal course of companies' business operations. Despite the difference between the restructuring activities during reorganization and those in the process of regular business operation, the tax treatments for restructuring activities are very similar to those for reorganization. Therefore, when handling the reorganization tax issues, parties should follow the current tax treatment rules for restructuring.

Reorganization provides the opportunity for distressed companies to recover and a second chance to survive. Choosing a proper approach is critical for the success of corporate reorganization because different approaches will lead to different tax consequences. Therefore, relevant parties shall devise a feasible and effective approach upon meticulous analysis and assessment of the tax impact to facilitate and implement a successful reorganization.

¶9-002 Provisions regarding tax treatment in corporate reorganization

Prior to 2008, China enforced a dual enterprise income tax regime, under which the foreign-invested enterprises (FIEs) and domestic enterprises (DEs) followed different income tax systems. In order to level the playing field for FIEs and DEs, China unified the enterprise income tax regime on January 1, 2008.

Income tax

(1) *Notice on Issues Relating to Treatment of Corporate Income Tax Arising from Corporate Restructuring* (*Circular No 59*);

(2) *Notice on Enterprise Income Tax Treatment for Companies into Liquidation* (*Circular No 60*);

(3) *Administrative Rules for Enterprise Income Tax for Corporate Restructuring* (*Announcement No 4*), provides further interpretation on the *Circular No 59*.

Value-added tax and business tax

At the end of 2008, the State Council promulgated the *Interim Regulations for Value-added Tax of the People's Republic of China* (*Interim Regulations for Value-added Tax*) and the *Interim Regulations for Business Tax of the People's Republic of China* (*Interim Regulations for Business Tax*), both of which became effective on January 1, 2009.

Others

Subsequently, a series of new transitional and ancillary rules and regulations were issued to implement the new value-added tax regime and business tax regimes. The promulgation of the said new tax laws and regulations, as well as China's improving tax law environment, may create new impacts on the transactions in corporate reorganization.

Main Approaches of Reorganization and Corresponding Tax Treatment

¶9-003 Main approaches of reorganization

According to the *Circular No 59*, a corporate restructuring may materially change the corporate legal structure or financial status of a company other than the day-to-day operational activities and have the following six approaches:

(1) Change of legal structure: change of company registration, including company name, business venue and organizational structure. In general, the said changes will not have any impact on the company's taxation. However, according to Article 4(1) of the *Circular No 59*, a company shall be regarded as going into liquidation, conducting asset distribution or establishing a new company with the sponsorship of existing shareholders when the company is restructured to a proprietorship, partnership and other types of non-legal person from a legal person, or changes its registered business venue within China to somewhere outside of China (including Hong Kong, Macao and Taiwan). In this case, the tax basis of the company's total assets and shareholders' capital contribution shall be calculated base on their fair value;

(2) Debt restructuring;
(3) Equity acquisition;
(4) Asset acquisition;
(5) Merger;
(6) Divestiture.

These six types of transactions are also the main approaches to implement corporate reorganization.

As different methods of reorganization may yield different tax consequences, an optimized approach may lower the tax cost of reorganization and maximize the benefits of the relevant parties. Aside from thoroughly understanding the relevant tax laws, regulations, and accounting rules, the parties should carefully structure the transaction framework and the reorganization plan.

¶9-004 Types of tax treatments of corporate restructuring

In the context of the enterprise income tax treatments, corporate restructuring can be classified into general restructuring and special restructuring.

In general restructuring, a company should recognize the gains or losses from transferring relevant assets or equities in the "current period."[1] Alternatively, a qualified company undergoing special restructuring may defer the recognition of the gains or losses from asset or equity transfers. In other words, the transferor of the relevant assets or equities may recognize the gains or losses when the relevant assets or equities are transferred in the subsequent transaction, instead of in the taxable year when the transactions initially occur.

¶9-005 Special restructuring — significance for corporations

If the parties to a special restructuring do not recognize the gains or losses from asset transfers in connection with the equity payments immediately after the transactions, they should recognize the gains and losses from assets transfers in connection with the non-equity payments in the current taxable year and adjust the tax base for the corresponding assets.

The parties should remember that the deferred tax treatment rules for special restructuring are not mandatory and companies engaging in special restructuring may decide whether to adopt the deferred tax treatment as needed.

The nature of deferred tax treatment is not a tax exemption or a preferential tax treatment, but a deferral arrangement to facilitate special restructuring as the restructuring company is often burdened with huge tax liability arising from non-cash payments it receives. The deferred tax treatment is critical for the company which is forced to conduct special restructuring because it may prevent the restructuring company from further financial distress and help facilitate the restructuring.

1 "Current period" refers to the taxable year (from January 1 to December 31) in which the transactions occur.

¶9-006 Special restructuring — conditions for deferred tax treatment

The deferred tax treatment is applicable when all of the following conditions for special restructuring are met:

(1) The company conducts the asset or equity transfer for a reasonable commercial purpose, instead of for the purposes of reduction, exemption or delay of its tax payment;

(2) The proportion of assets or equities acquired, merged or divested conforms with the relevant rules, in accordance with Article 6(2) and (3) of the *Circular No 59*;

(3) The company's substantive operating activities in association with the restructured assets should not change within 12 consecutive months after the completion of restructuring;

(4) The proportion of equity payment in the total consideration of a restructuring transaction conforms with the relevant rules of the *Circular No 59*, in accordance with Articles 6(2) and (3) of the *Circular No 59*; and

(5) According to Article 5 of the *Circular No 59*, the existing main shareholders[2] who received payment in equity as consideration during restructuring shall not transfer the said equity within 12 consecutive months[3] after the completion of restructuring.

¶9-007 Special restructuring — attentions when using special tax treatment

If a company conducts the special restructuring provided in the *Circular No 59* and applies special tax treatments to such a restructuring, the parties should submit filing materials in writing to the competent tax authority as required by *Announcement No 4* to demonstrate that the restructuring complies with all regulations and rules applicable to special restructuring. Where the company fails to perform the filing in writing as required, it cannot apply the tax treatments to special restructuring to the said restructuring.

2 According to Article 20 of *Announcement No 20*, the existing main shareholders refer to the shareholders that hold more than 20% of the equity of the transferor or the target company.

3 According to *Announcement No 4*, the commencement date of the restructuring shall be decided according to the following rules: (1) The commencement date for a debtor restructuring is the date on which the debt restructuring contract or agreement is executed; (2) The commencement date for an equity purchase is the date on which the equity purchase agreement is executed and the alternation of ownership registration is completed; (3) The commencement date for an asset acquisition is the date on which the asset purchase agreement is executed and the assets are delivered; (4) The commencement date for a merger is the date on which the acquirer obtains the ownership of the target company's assets and the alternation of business registration is completed; and (5) The commencement date for a spin-off is the date on which the spin-off company obtains the ownership of the parent company's assets and the alternation of business registration is completed.

¶9-008 Equity restructuring and corresponding tax treatment

Definition of equity restructuring

Equity restructuring refers to the restructuring of company via the introduction of the new investor(s). This commonly involves the equity transfer from the existing shareholder(s) to the new shareholders or issuance of additional shares to new shareholder(s). Furthermore, equity restructuring is subject to the enterprise income tax.

Tax treatment

In accordance with Article 4(3) of the *Circular No 59*, the tax treatment for equity restructuring shall follow the rules below:

(1) The shareholders of the target company (restructuring company) shall recognize the gains or losses from the equity transfers;

(2) The tax base for the transferred equity or assets shall be determined on the basis of the fair market value; and

(3) The relevant tax attribute of the target company should remain unchanged.

Tax treatment of special restructuring

In accordance with Article 5 and Article 6(2) of the *Circular No 59*, if the transferred equity consists of not less than 75% of the total equity of the restructuring company, and the value of equity payment for the transfer is not less than 85% of the total payment, and other requirements for special restructuring are met, the parties may elect to adopt the tax treatment rules below:

(1) The shareholder of the target enterprise shall take the original tax base of the acquired equity as the tax base of the equity consideration paid by the acquiring company.

(2) The acquiring company shall take the tax base of the target company, and such tax base shall be determined at the existing tax base of the target company of which equity is acquired.

(3) The tax base for all existing assets and liabilities and other tax attributes of the acquiring company and target company should remain unchanged.

¶9-009 Asset acquisition and corresponding tax treatment

Definition of asset acquisition

When a company (Acquiring Company) purchases the operating assets of another company (Target Company), it is known as asset acquisition. The forms of the consideration payment made by the Acquiring Company include equity, cash, non-equity assets, or a combination of the said methods. Asset acquisition is subject to the following taxes:

(1) Enterprise income tax;