

**Cross-Border Insolvency Law in China and Hong  
Kong: A Critical Analysis based on the UNCITRAL  
Model Law on Cross-Border Insolvency**

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The candidate confirms that the work submitted is his/her own, except where work which has formed part of jointly-authored publications has been included. The contribution of the candidate and the other authors to this work has been explicitly indicated below. The candidate confirms that appropriate credit has been given within the thesis where reference has been made to the work of others.

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## ABSTRACT

This thesis discusses what features and advantages of the Model Law regime that Chinese law could learn to improve the Chinese cross-border insolvency system at both international and regional levels. Cross-border insolvency is one inevitable consequence of the globalisation of business activity. For solving transnational insolvencies, there is a clash of competing national laws on issues, including the recognition of foreign claims, the process related to the distribution of assets, and different policy preferences for protecting different groups of creditors. The ongoing trend of harmonising cross-border insolvency laws has been actively promoted by the UNCITRAL Model Law on Cross-Border Insolvency. The Model Law was developed based on the principle of modified universalism, and its soft law nature aims to assist national insolvency laws and facilitate recognition of foreign proceedings. Although the interpretation of the law in enacting countries can be different, the thesis concludes that the Model Law can interconnect individual insolvency proceedings in an orderly and effective manner through its main features such as the centre of main interests (COMI) and cooperation and communication.

Cross-border insolvency rules in China are conservative, and the only relevant article (article 5 EBL 2006) sets the basic recognition rules, which have a restrictive application, based on the principle of reciprocity and bilateral agreements. However, after reviewing relevant Chinese laws for dealing with international matters, the thesis finds that there are legal concepts under the Chinese commercial law system sharing similarities with the Model Law system, which provide legal potential for China to adopt a modified universalism approach, and this study also argues that adopting COMI could be a good start to improving Chinese international insolvency law. As China includes various jurisdictions, this research also focuses on Hong Kong because of its legal and financial significance. Although Hong Kong has not developed statutory international insolvency law, there is a flexible common law approach, which can achieve similar results as the Model Law system. The interregional insolvency within China is a dilemma between treating cases from other regions (such as Hong Kong) as foreign matters and politically highlighting such matters as national matters. This thesis argues that the close political and economic connections between the mainland and Hong Kong require an effective interregional insolvency recognition regime and transplanting the Model Law regime into a regional context, applying a COMI-based recognition approach, could be a workable system.

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## Chapter 1 Introduction

This thesis is about whether the United Nations Commission on International Trade Law (UNCITRAL) Model Law on Cross-Border Insolvency could assist and provide a workable model for the reform of Chinese (and Hong Kong) interregional and international insolvency law. With the fast development of innovative technologies in communication and transportation, the trade barriers between different countries have been significantly reduced. As the result of faster and cheaper communication methods, people and institutions pursue profits and competitive advantages through cross-border flows of trading activities.<sup>1</sup> As Professor Westbrook argued, as the influence of transnational corporations on national and international markets continues to increase, one inevitable consequence is cross-border insolvency.<sup>2</sup> During the last few decades, while the regulation of multinational insolvency has made significant progress in the western world, the eastern developing countries are still at a primary stage in this specific legal area.

Generally, most countries' economy systems are market-oriented, so it is unavoidable that some international companies will meet financial problems and will be eliminated by market discipline. Following on from the company failures, there are complicated legal problems involved. Therefore, cross-border insolvency cases are directly caused by the rapid development of international enterprises and investment. In recent years, especially after the financial crisis in 2008, cross-border insolvency has received greater attention in both legal and business fields. The failure of a large multinational company may cause catastrophic effects in its industry or even for the entire global market; the insolvency of Lehman Brothers might be the most striking example, which involved 2985 legal entities in over 50 countries.<sup>3</sup> The significant

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<sup>1</sup> Rosalind Mason, 'Cross-Border Insolvency Law: Where Private International Law and Insolvency Law Meet', in Paul Omar (ed), *International Insolvency Law: Themes and Perspectives* (Ashgate 2008), 28–29.

<sup>2</sup> Jay Lawrence Westbrook, 'Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum' (1991) 65 *Am. Bankr. L.J.* 457.

<sup>3</sup> Andrew Cornford, 'The Failure of Cross-border Financial Firms: New Thinking in the Aftermath of the Financial Crisis' (2010) *Observatoire del la Finance* <

development of cross-border insolvency is the inspiration of this thesis. This introductory chapter sets out basic elements of this research, which includes four main parts. First, the research background and necessities of this research will be briefly discussed. Section 2 sets out the specific research questions of this thesis and thesis structure will be introduced in section 3. The last part explains the methodologies that will be used in the research.

## **1.1 Research Background and Necessities**

### **1.1.1 International Development**

Most literature agrees that solving cross-border insolvency needs a unified system and cooperation among the countries involved; therefore, international insolvency law can be identified as the legal area that deals with the conflict of laws that arises if an insolvent debtor's assets are in more than one jurisdiction.<sup>4</sup> Without a well-recognised system, cross-border insolvency may cause serious legal conflicts. For instance, forum shopping, which means 'identifying the optimal jurisdiction for the purpose of the restructuring or insolvency of a given company, and taking measures so that the law of that jurisdiction is applied',<sup>5</sup> is a cause of concern. Some international companies may try to find a legal vulnerability in existing systems and conduct activities to achieve a more favourable position. Moreover, identification of debtor's assets and verification of creditor's claims are the two fundamental processes for any insolvency proceedings, but it is impossible to accomplish effective and accurate outcomes without the cooperation of different jurisdictions. According to the World Bank, an acceptable system for international insolvency should be effective in achieving the "goal of maximising the value

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[http://d5769291.u920.sgohost.net/pdf/failure\\_of\\_crossborder\\_financial\\_firms\\_cornford.pdf](http://d5769291.u920.sgohost.net/pdf/failure_of_crossborder_financial_firms_cornford.pdf) > accessed 12 June 2017.

<sup>4</sup> Jenny Clift, 'UNCITRAL Model Law on Cross-Border Insolvency - A Legislative Framework to Facilitate Coordination and Cooperation in Cross-Border Insolvency' (2004) 12 *Tul. J. Int'l & Comp. L.* 307.

<sup>5</sup> Wolf-Georg Ringe, 'Forum Shopping under the EU Insolvency Regulation, Legal Research Paper Series' (2008) Oxford Legal Studies Research Paper 33/2008, 2 < [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1209822](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1209822) > accessed 18 June 2015.

of the debtor's worldwide assets, protecting the rights of the debtors and creditors and furthering of the just administration of the proceedings".<sup>6</sup> Although the importance of needing an efficient system for cross-border insolvency has been realised by most countries and international organisations, the development of international instruments has been slow since there are conflicts among different legal systems and domestic insolvency laws are usually the mirrors of an individual country's historical, political, cultural and social norms. Furthermore, local laws are always in favour of local interests and national benefits, so international cooperation could be limited and selective. One of the objectives of this thesis is to identify the essential difficulties and issues behind cross-border insolvency.

To solve the international issue, western countries have made significant efforts to bring greater harmonised rules in regulating cross-border insolvency proceedings over the last few decades, and, finally, the Model Law on Cross-Border Insolvency was introduced by the United Nations Commission on International Trade Law in 1997. The law has special features, which, unlike a multilateral convention, merely offers legislative guidance for states. The design of the articles was from a worldwide perspective, and they give individual nations the freedom to decide how to apply the provisions. The law provided a clear statement about the objective of the law: "to assist states to equip their insolvency laws with a modern, harmonised and fair framework to address more effectively instances of cross-border insolvency".<sup>7</sup> After the law had been published, the UNCITRAL provided different additional documents to promote the law and help countries adopt it, such as the Guide to the Enactment of the Model law and the Legislative Guide on Insolvency Law.<sup>8</sup>

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<sup>6</sup> World Bank, 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems' (2001) 53.

<sup>7</sup> UNCITRAL, 'UNCITRAL Model Law on Cross-Border Insolvency (1997)' <[http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html)> accessed 28 April 2015.

<sup>8</sup> UNCITRAL, 'UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation' <<http://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf>> accessed 28 March 2018; Legislative Guide on Insolvency

Moreover, many major international organisations also recommended the adoption of the law, for example, the group of G22 believed that the wider use of the Model Law would facilitate the efficient resolution of cross-border insolvency. The Monetary Fund, the World Bank and the Asian Development Bank also actively encourage the adoption of the law in various events.

The UNCITRAL has so far been adopted by 43 jurisdictions across the globe according to the UN record.<sup>9</sup> However, it is interesting to notice that the countries that have adopted the law reflect a diverse group of countries economically, and most of them are economically significant.<sup>10</sup> The insolvency law is a tool to solve the systemic market failures and whether one country has a clear and effective insolvency system decides the investment attractiveness of that country. According to the ranking of ease of doing business from the World Bank, half of the top ten countries (all developed countries) have adopted the Model Law.<sup>11</sup> Additionally, the European Union also adopted the EC Regulation on insolvency proceeding,<sup>12</sup> which applied some similar theories to the Model Law. As a consequence, it can be observed that the countries that have applied the Model Law and are covered by the EC Regulation include almost all major advanced economies. For other less-developed countries, there are still no unified regimes that have been widely accepted. Therefore, the question is whether the Model law is a perfect tool to facilitate cross-border insolvency for all the countries or a tool suitable only for economically developed countries.

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Law, <[http://www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf)> accessed 28 March 2018.

<sup>9</sup> UNCITRAL, 'Status: UNCITRAL Model Law on Cross-Border Insolvency (1997)', <[http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model\\_status.htm](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model_status.htm)> accessed 28 March 2018.

<sup>10</sup> Steven T Kargman, 'Emerging Economies and Cross-Border Insolvency Regimes: Missing BRICs in the International Insolvency Architecture (Part I)' (2012) *Insolvency and Restructuring International* 8.

<sup>11</sup> World Bank Group, *Doing Business 2015: Going beyond Efficiency* (12<sup>th</sup> Edition, International Bank for Reconstruction and Development / The World Bank, 2014).

<sup>12</sup> Council Regulation (EC) 2015/848 of 20 May 2015 on Insolvency Proceedings [2015] OJ L141/19.

## 1.1.2 Cross-border Insolvency Law in China

### Slow Development

In mainland China, the development of insolvency law has been very limited, and the legal area of cross-border insolvency is still a relatively new concept under Chinese law. At the early stage (the 1950s) of newly-established China, most enterprises and banks were owned by the government and private investment and companies were not allowed. The business activities of those state-owned-enterprises (SOEs) were conducted according to official guidance; even though there were some financially distressed SOEs, the government would not let them be wound up since the results of this would cause social instability.<sup>13</sup> So there was no point in building an insolvency system under such protection, and also it was impossible for the creditors to enforce their claims against debtors. The new chapter of the Chinese economy started at the end of 1978 due to the launch of the Reform and Opening up Policy, which changed the planned economy to a market economy. In order to assist the economic transition, the legal reforms used the experiences from advanced countries to build the first insolvency law of China. However, the purpose of the law was to protect state sovereignty and local creditors and only applied to SOEs; additionally the law did not include any articles for the cases with international elements.<sup>14</sup> The international cases needed to open duplicated proceedings in a Chinese court. During this period, insolvency practitioners had to find answers from the insolvency section of the Civil Procedure Law,<sup>15</sup> but the articles were too simple and vague to address any practical cross-border insolvency problems.

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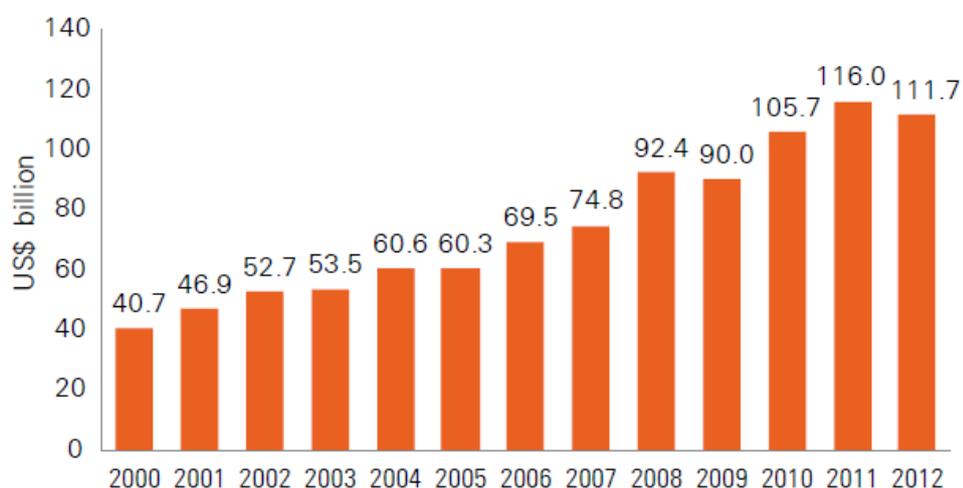
<sup>13</sup> Zhang Haizheng and Gao Ran, 'An Analysis of Cross-Border Insolvency in China's New Bankruptcy Law: A Big Step Forward' (2011) *International Corporate Rescue* 93.

<sup>14</sup> The Enterprise Bankruptcy Law of the People's Republic of China 1986; Steven J. Arsenault, 'Leaping over the Great Wall: Examining Cross-Border Insolvency in China under the Chinese Corporate Bankruptcy Law' (2011) 21 *Ind. Int'l & Comp. L. Rev.* 1.

<sup>15</sup> Chapter 19 Procedure for Bankruptcy and Debt Repayment of Legal Person Enterprises, Civil Procedure Law of the People's Republic of China 1991.

With the rapid development of the Chinese economy and international relations, both internal and external factors required a new insolvency system to replace the outdated one. The open market for social and private security and the banking industry promoted the new law to protect their interests; from outside, the US and the European Union have pressured the government to make a new bankruptcy law.<sup>16</sup> In 2007, the new Enterprise Bankruptcy Law<sup>17</sup> came into force, which was also modelled on legally advanced countries' laws and philosophies, and the main objective was that it was "formulated in order to regulate the procedure of corporate bankruptcy, to wind up debts and indebtedness fairly, to protect the legitimate rights and interests of creditors and debtors, and to maintain the order of the socialist market economy".<sup>18</sup> Compared with the previous version, the new law shows some notable changes, such as the reorganisation process and a special article for the insolvency of financial institutions. Moreover, for the first time, the Chinese law addressed the problem of international insolvency problems.

Inbound FDI in China, 2000-2012



(Source: KPMG, 2013)

<sup>16</sup> Zhang Haizheng and Gao Ran (n 13) 98.

<sup>17</sup> The Enterprise Bankruptcy Law of People's Republic of China 2006 (EBL 2006).

<sup>18</sup> Adam Li, 'China: Bankruptcy and Insolvency Law and Policy' (2006) *The Law of International Insolvency and Debt Restructurings* 127.

As one of the most important economies in the world, and with the open up policy having been applied deeper and wider, the Chinese market has become one of the most attractive investment destinations in the world. According to the chart above, inbound Foreign Direct Investment (FDI) has been steadily increasing since 2000 and has exceeded 100 billion US dollars every year since 2010.<sup>19</sup> Moreover, an increasing number of Chinese investors are trying to expand their business activities into the global market, which means that insolvency cases with international elements from both outbound and inbound would increase as well.

### **“Big” Step of the New Bankruptcy Law**

The new law addressed the international insolvency problem for the first time. However, with only one article, it is impossible to solve specific issues relating to cross-border insolvency. There are two paragraphs under this article. The first one regards the extraterritorial effects of Chinese proceedings, which makes it clear that the proceedings initiated in a Chinese court are binding on the debtor’s assets located inside and outside of China. The second addresses the recognition of foreign bankruptcy judgments, which stated the recognition and enforcement subject to the condition that the judgments do not offend Chinese public policies and local interests.

#### Article 5<sup>20</sup>:

“The bankruptcy proceedings opened by the People’s Court under this law shall have effects on the assets of the debtor located outside of the territory of the People’s Republic of China.

Where any legally effective judgment or ruling made by a foreign court involves any debtor’s assets within the territory of the People’s Republic of China and if the representatives applies to or requests the people’s court to recognize or enforce it, the people’s court shall, according to the relevant international treaties that China has concluded or acceded to or according to the principles

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<sup>19</sup> KPMG, ‘Investment in the People’s Republic of China’ (2013) <<http://www.kpmg.com/CN/en/IssuesAndInsights/ArticlesPublications/Documents/Investment-in-China-201311.pdf>> accessed 20<sup>th</sup> January 2015.

<sup>20</sup> Article 5, EBL 2006 (China).

of reciprocity, conduct an examination thereon and, when believing that it does not violate the basic principles of the laws of the People's Republic of China, does not damage the sovereignty, safety or social public interests of the state, does not damage the legitimate rights and interests of the creditors within the territory of the People's Republic of China, grant recognition and permission for enforcement. ”

Unfortunately, although this was a big step for the Chinese insolvency system, only one article is not sufficient. The article 5 stated that the Chinese courts have jurisdiction over both local and overseas assets, which means all these assets should be put into a pool of assets for distribution based on the Chinese law's distributive rules. However, in judicial practice, the realisation of legal effects on overseas assets always depends on the corresponding regulations of countries where those properties are located. The article also implies that once the Chinese court has accepted the application, all the assets of the insolvent debtor should be handed over to an administrator appointed by China; moreover, any preference for using the debtor's foreign assets shall be invalidated, and execution of those assets should be discontinued. If the purpose of the first paragraph is to clarify the position of the law's extraterritorial effects, the second paragraph could be more imprecise.

The process of recognising foreign judgments can be divided into two steps. The first is the examination of international treaties or the principle of reciprocity between China and the involved foreign country; on the condition that there are no such conditions, the Chinese court can adjudge that no recognition of foreign judgment shall be granted. If the international treaties do exist or the principle of reciprocity can be applied, the second step is to examine whether the foreign judgments violate the basic principle of Chinese laws, which is not to damage the sovereignty and public interests and the interests of Chinese creditors. The recognition and enforcement only will be granted when the two conditions are both satisfied. It seems that Chinese law tries to add double insurance about recognition of the foreign judgments. Without clear interpretation, this article will potentially lead to serious concerns regarding the enforceability of foreign judgments. To sum up, the current

provisions about cross-border insolvency just provided a basic principle of international insolvency and only touched upon the essential problems with unclear language, and also did not address substantive issues, which may cause conflicts in practice.

More importantly, cross-border insolvency law is supposed to encourage the confidence of foreign investors and improve the environment for foreign investment by improving the certainty and predictability of the law.<sup>21</sup> The unclear language may undermine these goals since the investors cannot analyse the risks associated with specific trading. Especially, the wording of the second paragraph can be interpreted by foreign creditors as an unfair protective rule for state and local creditors. Although the law should provide safety to prevent local creditors from injustice distribution, finding the balance point is important. Therefore, specific guidance on cross-border insolvency procedures and practical issues is urgently needed under Chinese law.

### **Interregional Issues within China: Hong Kong as Example**

When discussing legal issues within China, the fact that China is a country with various jurisdictions cannot be ignored. There are four independent jurisdictions, including the mainland, Hong Kong, Macao and Taiwan, which operate simultaneously and equally within one country. As Taiwan is a politically disputed region and currently is not controlled by the central government of China, the legal issues of Taiwan are not included in this research. China's interregional problems are mainly generated by the "One Country, Two Systems" policy, which was adopted in the Sino-British Joint Declaration and Sino-Portuguese Joint Declaration to resume the sovereignty of Hong Kong and Macau.<sup>22</sup> Those two areas are now Special Administrative

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<sup>21</sup> Fernando Locatelli, 'International Trade and Insolvency Law: Is the UNCITRAL Model Law on Cross-Border Insolvency an Answer for Brazil? (An Economic Analysis of its Benefits on International Trade)' (2008) 14 (2) *Law and Business Review of the Americas* 314.

<sup>22</sup> Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong; Joint declaration of the Government of the People's Republic of China and The Government of the Republic of Portugal on the question of Macao.

Regions of China (SARs). The Basic Law, which formalised the “one country, two systems” concept, serves as the legal foundation between the central government and its SARs.<sup>23</sup> While the Basic Law emphasises that the central government is the sole authority, the main ideas of the law are to keep social and legal orders unchanged in Hong Kong and Macao after the reunification, and to make it clear that the autonomy of the SARs and law of the mainland will not be enforced in SARs.<sup>24</sup> Although the legal systems of each of the regions are relatively independent, interregional legal issues among different regions require special discussion because of the close economic, geographical, historical and cultural connections. For insolvency issues, since insolvency proceedings are usually a collective debt collection system, a higher degree of cooperation at the national level should be more effective and easier than using international rules. However, there is no cooperative system within China to facilitate interregional insolvency. So this thesis is trying to explore the potential solutions to interregional legal issues.

To make a comprehensive analysis of the interregional insolvency issues in China, it is important to understand the insolvency system of each region, and their similarities and differences will be the foundation in the development of regional solutions. For this thesis, Hong Kong is going to be analysed in detail. As one of the influential financial centres, Hong Kong has been an important investment destination; after the reunification, foreign investors have been using it as an investment channel to enter the mainland market. Therefore, compared to Macao, conducting research into Hong Kong’s insolvency system and its connection with the mainland would have more legal and financial significance. Furthermore, the central government usually adopts the same approaches to deal with SARs’ issues, thus the research into Hong Kong will have potential implications for Macao.

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<sup>23</sup> The Basic Law of the Hong Kong Special Administrative Region (HKSAR) was adopted on 4 April 1990, and came into effect on 1 July 1997; The Basic Law of the Macao Special Administrative Region (Macao SAR) of the People's Republic of China adopted on March 31, 1993 and came into effect on 20 December 1999. The two laws are generally the same in structure and contents.

<sup>24</sup> Article 8, 18, The Basic Law of HKSAR (Hong Kong); Article 8, 18, The Basic Law of Macao SAR (Macao).

## ***Hong Kong***

Because of its colonial history, the Hong Kong legal system is based on the English law, supplemented by local legislation. For the insolvency system, therefore, the courts can always find references to case law. When a foreign insolvency representative is trying to find recognition from the Hong Kong courts, traditionally, the courts are willing to cooperate and assist the foreign proceedings based on the common law power.<sup>25</sup> However, there is no comprehensive statutory framework offering a legal basis for recognising foreign insolvency proceedings.

Additionally, Hong Kong courts have the statutory power to wind up “unregistered companies” under the Companies Ordinance.<sup>26</sup> Therefore a foreign insolvency practitioner can also seek a winding up order in the Hong Kong courts to protect or gain control over assets located in Hong Kong. This provision gives courts the right to wind up non-Hong Kong companies, but it only deals with one aspect of international insolvency, ignoring problems such as recognition of foreign insolvency proceedings and foreign-appointed liquidators. It must be noticed that jurisdiction issues play an important role in cross-border insolvency law in Hong Kong due to the lack of a formal cross-border insolvency cooperation regime.<sup>27</sup> According to section 327, Hong Kong’s courts have discretionary power over companies that are unregistered in Hong Kong. However, based on case law, it has been clarified that this wide statutory term does not mean the courts have unlimited jurisdiction.<sup>28</sup> The case law has adopted a “sufficient connection” test to limit the statutory power (a detailed discussion of this is in chapter 5). Recent case laws seem to suggest that Hong Kong judges have been using the jurisdiction rules flexibly

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<sup>25</sup> E. L. G. Tyler, ‘Insolvency Law in Hong Kong’, in Roman Tomasic (ed), *Insolvency Law in East Asia* (Ashgate Publishing Company 2006) 223.

<sup>26</sup> Section 327, Cap. 32 Companies (Winding Up and Miscellaneous Provisions) Ordinance (Hong Kong).

<sup>27</sup> Xinyi Gong, ‘A Balanced Way for China’s Inter-Regional Cross-Border Insolvency Cooperation’ (PhD Thesis, Leiden University 2016) 68.

<sup>28</sup> *Re Chime Corporation Limited* [2004] 7 HKCFAR 546, para 40.

and innovatively.<sup>29</sup> Since Hong Kong has not enacted the UNCITRAL Model Law, one purpose of this research is to see whether the Hong Kong courts have developed effective cross-border insolvency solutions.

Regarding the interregional insolvency issues between the mainland and Hong Kong, courts from both regions still treat cases from the other region as foreign matters. There are no provisions under Hong Kong law that give special treatment for recognising insolvency judgments issued by mainland courts. Therefore it could be assumed that the mainland's insolvent companies also will be treated as foreign companies. In the mainland, the Supreme People's Court has issued inconsistent opinions relating to the treatment of Hong Kong insolvency matters. According to the Provisions on Issues Concerning the Jurisdiction over Foreign-related Civil and Commercial Cases in 2002,<sup>30</sup> the cases involving the element of Hong Kong, Macau and Taiwan should be treated as foreign matters. This seems to imply that Article 5 of the new bankruptcy law is applicable to those Special Administrative Areas as foreign jurisdictions. In practice, most judges of the mainland courts also regarded Hong Kong as a foreign element.<sup>31</sup>

In contrast, in 2011, the High Court of Beijing referred a case to the Supreme People's Court requesting clarification on whether or not the winding-up order issued by the High Court of Hong Kong can be recognised in the mainland, and the Supreme People's Court replied that Article 5 and relevant articles under the Civil Procedure Law, which regulate recognition and enforcement of foreign judgments, could not be applied to this Hong Kong-related case.<sup>32</sup> The central government always emphasises its sovereignty over Hong Kong, and Hong Kong-related issues are national issues, so treating Hong Kong

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<sup>29</sup> For instance: *In re Yung Kee Holdings Limited* [2012] 6 HKC 246; *Re Pioneer Iron and Steel Co. Ltd* [2013] HKCFI 324 (discussion in Chapter 5).

<sup>30</sup> Provisions of the Supreme People's Court on Some Issues Concerning the Jurisdiction of Civil and Commercial Cases Involving Foreign Elements, The Supreme People's Court [2002] Judicial Interpretation No. 5.

<sup>31</sup> For instance: *Gu Laiyun and others v Nardu Company Limited* [2006] Guangzhou Intermediate People's Court Civil Division IV First Instance No. 44.

<sup>32</sup> *NORSTAR Automobile Industrial Holding Limited* [2011] Supreme People's Court Civil Other No. 19.

cases as a foreign matter is obviously not the intention of the highest court—but without a relevant legal solution, the only option seems to use foreign-related rules. This reflects the reality that there is a lack of a corresponding legislative and judicial approach to connect the two legal systems in the country, and conducting research about cross-border insolvency in both areas would provide a chance to explore the solution to the dilemma.

## 1.2 Research Questions

The purpose of this thesis is to explore the possible theoretical support for the reform of Chinese and Hong Kong law on international insolvency based on the analysis of the regime proposed by the UNCITRAL Model Law on Cross-Border Insolvency. Specifically, this thesis seeks to answer five main questions:

**First**, the research attempts to discover the fundamental issues of the cross-border insolvency and the importance of this particular area in modern business society, including its nature and definition, its development, the principle concepts behind the laws and the current regimes for solving cross-border insolvency.

**Second**, the thesis will examine whether the UNCITRAL Model Law on Cross-Border Insolvency is effective enough to solve multinational insolvency cases. This is because the Model Law has been marked and promoted as an effective regime by international organisations. This question will focus on investigating the special features and interpretations of the law in practice.

**Third**, the thesis explores why the only article under the Chinese Enterprise Bankruptcy Law 2006 is not enough to solve international insolvency cases and what issues it has caused in practice.<sup>33</sup> In particular, relevant historical and political factors will be examined to understand the rationales and legislative gaps in developing Chinese insolvency and cross-border insolvency systems.

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<sup>33</sup> Article 5, EBL 2006 (China).

**Fourth**, the research asks whether the Hong Kong legal system, which is independent of the Chinese legal system, could provide an effective solution for international insolvency. Specifically, this question explores the influences of international business development on Hong Kong's common law approach for international insolvency.

**Finally**, the research examines how the political arrangement "one country, two systems" changed the legal relationship between the mainland and Hong Kong and its influences on the interregional insolvency issues. This question explores whether international experience could provide references for solving interregional issues within China.

### **1.3 Thesis Structure**

Chapter 2, which considers the first research question, will focus on the review of basic concepts and features of the area of insolvency. It will explain the natures of insolvency and cross-border insolvency, and how the different locations of the insolvent debtor's assets and the creditors could be the fundamental difference between domestic and international insolvency. Then the chapter will explore why this fundamental difference makes cross-border insolvency such a difficult subject. The three essential problems that cross-border insolvency laws are trying to solve include identification of jurisdiction, choice-of-law and recognition and enforcement of foreign judgments, so the chapter also explains the importance of finding a unified system for international insolvency.

Next, the chapter discusses the theories put forward for solving the multinational insolvency issues. Universalism and territorialism are the two dominant theories. The former means one jurisdiction plays the main role in dealing with the collection, administration and distribution of all the debtor's assets, the latter means proceedings should be limited to the assets within the individual national territory. Since universalism emphasises the efficiency and integrity of whole proceedings and territorialism pays more attention to national sovereignty, the chapter examines why it is impossible to adopt a

pure version of the two theories. Currently, modified universalism seems to be the most accepted and effective system because it mixes the advantages of two pure concepts, these advantages will be discussed. The UNCITRAL Model law and the EC regulation on insolvency proceedings could both be seen as examples applying modified universalism.

Next, chapter 3 will be connected with the second research question, which will concentrate on the development and application of the UNCITRAL Model Law. After the long history of chaos in this legal area, the introduction of the Model Law seems to provide a unified regime to encourage cooperation and assistance between different courts. The main features of the law will be analysed, including the language and the rationale behind it. In particular, based on the concepts of the second chapter, the modified universalism encourages the efficiency and predictability of cross-border insolvency. The chapter will review the fundamental legal frameworks the Model Law proposed based on the theories mentioned in the previous chapter, to explore whether the law can solve cross-border insolvency effectively. Especially, the law is allowed to be modified at the national level, so the application of the law may be different in enacting countries. In order to explore the real meaning of the Model Law system and more importantly how its features could improve and assist the domestic insolvency system, the significant cases from enacting countries, including the US and the UK, will be discussed to show the use of the Law in practice.

To answer research question three, background information and the current law of the Chinese insolvency system will be carefully reviewed in chapter 4. Because of the political and historical factors, the Chinese economy was a planned economy for a fairly long time, and all the business activities were centrally controlled by the government. Therefore, the development of the insolvency system under the Chinese legal system was very limited. After the opening up policy, with the rapid development of the national and international economy, many foreign-funded companies have started to influence the economic development of China. So a clear insolvency system, especially for cross-border insolvency issues, is needed for the health of the Chinese market. Although the new bankruptcy system (European Bankruptcy Law

(EBL) 2006) addressed this issue for the first time in Article 5, the unclear interpretation and lack of guidance make it difficult to apply in practice. The operation of the cross-border insolvency article heavily depends on international treaties or the principle of reciprocity, and it has potential to be used as a protective method. Therefore, the rationale behind this article will be discussed. A comparative study between Chinese law and the Model Law also will be conducted. The purpose of this is to identify the shortcomings of Chinese law based on the characteristics of the Model Law and the necessities for potential improvements.

Chapter 5 will focus on the current insolvency system of Hong Kong. As a special administration area of China, its legal system is based on the common law system. The current system for cross-border insolvency in Hong Kong is more comprehensive than Chinese law. As one of the most influential global financial centres, it is strange to see that Hong Kong still has not established its own corporate rescue and international insolvency regulations. However, based on common law principles, Hong Kong courts had a good history of cooperation with foreign courts regarding multinational insolvency cases, and the willingness to apply flexible approaches when it is appropriate to solve modern international business issues. The comparison between the Hong Kong system and the Model Law will also be conducted in this chapter. For answering research question four, the comparison will examine whether the common law approach in Hong Kong could solve cross-border insolvency.

Chapter 6 tries to solve the last research question. Because of the “one country, two systems” policy, the mainland and Hong Kong are two different jurisdictions in the same country. Although they have close political and economic connections, interregional insolvency issues between the two areas have not been effectively addressed. For example, the mainland courts are still treating the insolvency cases from Hong Kong as foreign matters, and the mutual judgment recognition agreement had limited application and failed to cover any insolvency issues.<sup>34</sup> Such a legal gap is not consistent with the

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<sup>34</sup> Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong SAR Pursuant to Choice of Court Agreements between Parties Concerned 2006.

political and economic intentions of the Hong Kong authority and central government. For solving such an issue, mutual judgment recognition regarding interregional insolvency between the two regions could be a good starting point. The purpose of this chapter is to review the complexities of the interregional issues based on political and legal influences and explore whether the UNCITRAL Model Law could have potential application to solve those issues.

Chapter 7 will address the issues of corporate group insolvency in China. This chapter will be a supplementary discussion of current issues within the Chinese insolvency system (chapter 4). Chinese corporate groups are closely connected with the development of state-owned enterprises in different historical periods. Even though the Chinese insolvency system has not addressed the insolvency issues of corporate groups, courts have used practical approaches such as substantive consolidation. As insolvency of corporate groups has become an urgent issue under both the UNCITRAL Model Law and the European Insolvency Regulation, the purpose of this chapter is to discuss what experiences and principles of the two international regimes the Chinese law can learn from for the codification of corporate group insolvency at both national and international levels.

The last chapter will conclude the whole thesis and address to what extent the research questions have been answered. Potential implications of improving the Chinese insolvency system will be summarised. Research limitations and future research areas will also be discussed.

## **1.4 Methodology**

Based on the background information and the primary outline of this thesis, there are several different legal systems from various jurisdictions that will be involved in this thesis. Therefore, it is important to ensure the efficiency and accessibility of all necessary research information. This part describes the methods used for this thesis and its necessities. Discussion of these methods

can also clarify the structure of the thesis and highlight the strengths and limitations of those methods.

#### **1.4.1 Qualitative Research**

Qualitative research methods will be the main system the thesis applies, which are a valid and reliable method for social research.<sup>35</sup> According to Dobinson and Johns theories, the qualitative legal research can be divided into two different types: doctrinal and non-doctrinal research.<sup>36</sup> Doctrinal research can be defined as research which asks what the law is in a particular area, which always involves analysis of case law and related legislation. It is one of the most important legal research systems since it is the process used to identify, analyse and synthesise the content of the law, with the aim to help the researchers understand certain legal areas.<sup>37</sup> All the other research, like specific socio-legal issues or policy and law reform, can be identified as non-doctrinal.<sup>38</sup> In modern legal society, the doctrinal and non-doctrinal areas always link to each other, so it is normal that a research project involves both methods. The development of a certain legal area is always influenced by many factors, such as cultures, economic development and new social trends; therefore, legal research without considering non-doctrinal factors may not be valid.

For this thesis, one primary aim is to investigate the application of the Model Law on Cross-Border Insolvency and its influences on different jurisdictions, which will be appropriate to conduct the doctrinal study, including the practical case studies and analysis of specific law provisions. Another important part is about the studies of Chinese and Hong Kong insolvency systems, which will need both research methods. For example, as mentioned in previous parts the current Chinese law for international insolvency problems is still vague and

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<sup>35</sup> Bruce L, Berg, *Qualitative Research for the Social Sciences* (4<sup>th</sup> edn, Allyn & Bacon 2001) 10.

<sup>36</sup> Mike McConville and Wing Hong Chui, *Research Methods for Law* (Edinburgh University Press 2007) 17.

<sup>37</sup> Dawn Watkins and Mandy Burton, *Research Method in Law* (Routledge Ltd, 2013) 7.

<sup>38</sup> Mike McConville and Wing Hong Chui (n 36) 20.

ambiguous, so the reasons the current law need to be improved will be discussed in this thesis, and this will include both legal and social factors.

### **1.4.2 Information Collection**

For qualitative research, the most vital step following the research questions is to select the right databases for correct information, because the documents-based research depends on analysing the existing information to find what the researchers need.<sup>39</sup> The methodology should be thorough, systemic, justifiable and reproducible.<sup>40</sup> The data and information volume for this thesis will be enormous since it involves various jurisdictions and legal systems, thus it requires the collection methods to be valid and reliable. The specific methods and contents will be discussed below.

#### **The UNCITRAL Model Law Databases**

**Legislation:** The original version of the Model Law can be found on the United Nation's website, alongside other supportive documents, such as the previous reports of the Working Groups and versions of the guidance to enactment.<sup>41</sup> The information will show the big picture of the Model Law's background and development process, and help the researcher to understand the basic principles behind the design of the law. Since the law can be modified by the individual nation to fit into its own national law system, the adapted national version of the law can be accessed on government websites.

**Case Study:** The jurisdictions mainly focus on two main countries that have already adopted the Model Law, the US and the UK, since the two countries have solid histories dealing with cross-border insolvency cases and a more well-established legal system, and therefore the study of their cases could be more justified to show the law's functions. Moreover, the judgments from courts in those countries always draw serious attention and affect the law in

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<sup>39</sup> *ibid.*

<sup>40</sup> Peter Cane and Herbert Kritzer, *The Oxford Handbook of Empirical Legal Research* (Oxford University Press 2010).

<sup>41</sup> UNCITRAL: [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997\\_Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997_Model.html).

other jurisdictions. For the databases of those cases, Westlaw UK and Lexis Library provide most filed cases of the UK courts and some important cases from other jurisdictions including the US and Europe.

### **China and Hong Kong Databases**

For the information on China and Hong Kong, because of their lack of experience in this particular legal area, the information could be considered difficult to collect. In the mainland, the publicity of legal information and judgments is still at an early stage. There was no requirement for publishing court judgments until January 2014. The Supreme People's Courts established the case database for central public access to the judgments of all levels, which only provides case judgments that were finalised after 1 January 2014.<sup>42</sup> As for international insolvency cases, because of the territorial approach that the Chinese law and judges traditionally adopted, information on international insolvency cases is very limited. Therefore, the main information about China depends on supporting documents from non-government organisations' reports, professional legal practitioners' organisations and other scholars' research articles in China and overseas. For the information on Hong Kong, the legislation and regulations can be accessed from both the government websites of China and Hong Kong. Hong Kong has a well-established case publicity system so detailed case reports can be accessed online. Moreover, as Hong Kong still applies the common law system, some published information and cases can also be found from the UK databases, such as Westlaw.

#### **1.4.3 Comparative Study**

The other method the thesis will use is comparative study. Comparative law is a young branch of legal studies, which focuses on the research of

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<sup>42</sup> Provisions of the Supreme People's Court on the Issuance of Judgments on the Internet by the People's Courts, The Supreme People's Court [2013] Judicial Interpretation No. 26 the database: <<http://wenshu.court.gov.cn/>> accessed on 20 April 2018.

differences and similarities between different nations.<sup>43</sup> This method has useful functions and advantages when formulating legal research. First, it helps one attain a deeper understanding of the current law, and to realise the gaps and shortcomings of the law. There is no perfect legal system in the world, since laws are always in the process of development process alongside the development of the society; hence, comparative law is the opportunity to learn from other legal systems, after which improvements can be made to the current law. Foreign laws could be very helpful when a country needs to reconstruct their legal system, especially for some developing countries. Furthermore, for legal areas like international insolvency, possibly, international cooperation and harmonisation will be encouraged through the process of comparison. Therefore, the method of comparative law can be a good technique for research into cross-border insolvency. For this thesis, the comparative method will be used to compare the system of the Model Law on Cross-Border Insolvency with Chinese law and Hong Kong law.

### **The Subjects of Comparison**

From the perspective of China and Hong Kong, it is also necessary to conduct a comparison. As mentioned before, Chinese law's position on cross-border insolvency shows an imbalance compared to the rapidly increasing number of foreign enterprises in mainland China. Thus, to understand where the shortcomings are is good for the future development of Chinese law. Hong Kong would be a more interesting subject to analyse. Before the sovereignty of Hong Kong transferred to the Chinese government, the National People's Congress (NPC) of China adopted the Basic Law of Hong Kong Special Administrative Region (HKSAR).<sup>44</sup> The law stated that after Hong Kong reverted back to the Chinese government, the main legal system would not

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<sup>43</sup> Pier Giuseppe Moneteri, *Methods of Comparative law* (Edward Elgar Publishing Ltd, 2012).

<sup>44</sup> The National People's Congress (NPC): the national legislature of the People's Republic of China; Special Administrative Regions: are autonomous territories that fall within the sovereignty of the People's Republic of China, including Hong Kong and Macao.

be changed, and principles, like the common law, rules of equity, ordinances, subordinate legislation and customary law, would continue to apply in Hong Kong. Moreover, the Hong Kong government also has more rights of autonomy, such as to make their laws and regulations subject to Chinese constitution law. Therefore, it is necessary to research how a jurisdiction in such a special position will solve an international issue.

### **Comparison System**

Normally, the comparison may include three perspectives: the general culture of the laws; black letter laws, such as legislation and treaties; and application in practice.<sup>45</sup> Accordingly, the comparisons in this thesis will be divided into two main parts. The first part will focus on the structures of laws, which means the comparison is to explore the laws on a theoretical level. For instance, the historical background of the design and necessities of law could play a vital role in its wordings and future application. The concepts behind the laws will also be discussed. In the area of cross-border insolvency, the universalism and territorialism are well-recognised theories; therefore, to discuss which approach that different legal system adopted is the starting point of researching the law. Furthermore, a comparison of wordings that different laws used will be conducted. Sometimes, a specific word in a legal article can reflect the attitudes of lawmakers and the objectives that the law was intended to achieve. The Model Law could be a very good example of this. When the term “adequately protected” changed to “sufficient protection”,<sup>46</sup> the courts’ power allowed by the law also changed. For this thesis, the subjects are an international instrument that has no binding power and national laws in different jurisdictions, so comparing the approaches and concepts behind the wording is the main task here. Based on this part, a comparison can not only

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<sup>45</sup> Jaap Hage, ‘Comparative Law as Method and the Method of Comparative’ (2014), Maastricht European Private Law Institute Working Paper 11/2014 <[http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2441090](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2441090)> accessed 20 December 2014.

<sup>46</sup> The difference between article 21 of the Model law and the section 1521 of Chapter 15 of the US Bankruptcy Code.

identify the similarities and differences of those insolvency systems, but more importantly, can also demonstrate gaps between national and international levels, which is closely related to one of the main research questions.

After the research around the laws themselves, the application of them in practice will be compared in the second part. Through the research of real cases solved by different laws, this part will illustrate the features of laws from a more direct and clearer angle; moreover, the approaches that the local courts applied to the conducted law also provide an opportunity to understand them objectively. For example, with the rapid process of globalisation, the “offshore companies” cases might be an important type of cross-border insolvency cases. When an insolvent business is registered in a so-called “tax haven” jurisdiction and conducted most of their business activities in another nation, the issues, such as which country has jurisdiction to open insolvency proceedings, the location of company’s main interests or the methods to deal with assets in other jurisdictions, may cause legal disputes among different jurisdictions. Therefore, in this part, different solutions for this kind of cases under the Model Law and Chinese / Hong Kong laws will be covered. As well as complementing the discussion of the first part, performing this analysis is a good method for seeing whether the Model Law is an effective regime for international insolvency as well.

#### **1.4.4 Conclusion and Information Reliability**

In conclusion, qualitative research will be conducted for this thesis. Specifically, the doctrinal study is the main method to research the Model Law on Cross-Border Insolvency, and the information databases include legislation and cases from various jurisdictions, and also secondary sources based in libraries and on the internet. Those databases should provide as much information as feasible. Moreover, professional websites will be used to collect information on Chinese law and Hong Kong law, and search terms for these two jurisdictions will be used in both Chinese and English to cover the most possible databases. Based on the information collected, the method of comparisons will also be undertaken to study the differences between the Model Law and the two legal systems existing in China. From two

perspectives of comparison, a detailed picture of the development of the legal area under those jurisdictions will be shown.

Since most of the information will be collected on the internet, the issue of information reliability should be noted. To guarantee reliability as much as possible, only government websites and professional websites or legal information providers will be used. The articles collected from search engines (Google and Baidu) will be revised and evaluated critically based on the authors, publishing organisations or year published. Overall, strict screening standards will be conducted during the collection process.

## Chapter 2 The Nature of Cross-Border Insolvency

Because international cases always involve more than one jurisdiction, complicated legal issues and potential conflicts may arise, such as which country has the jurisdiction to open proceedings against the international debtor, or which law should be applied to govern the proceedings. Generally, the same problem can be solved by completely different methods under different jurisdictions since differing nations' insolvency laws illustrate differing balances of political considerations and the nature of social arrangements;<sup>1</sup> so, a chaotic situation may arise since the creditors and assets are all in different countries. That is the major reason why issues of domestic insolvency will be more difficult to solve at the global level. As a result, to understand the principle issues needed to be addressed under cross-border insolvency laws, it is necessary for us to have an insight into the phenomenon of insolvency. By getting to the bottom of the issue, it will also provide theoretical support for the research of specific jurisdictions in future chapters.

This chapter will focus on the elaboration of the nature of insolvency and the inherent complexity of cross-border insolvency, which explains why this specific legal area is important at both domestic and international levels. First, the various trigger points of insolvency and their applications in different jurisdictions will be discussed. Then, the following section addresses the three main common goals among different insolvency systems: encouraging cooperation among creditors, achieving fair distribution and improving market stability. Section 3 considers why regulating cross-border insolvency is difficult based on three fundamental issues---jurisdiction, choice of law and recognition. Section 4 discusses how the theories of solving international insolvency-universalism and territorialism-have been developed, and their applications at international and national law level.

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<sup>1</sup> Gerard McCormack, 'Universalism in Insolvency Proceedings and the Common Law' (2012) 32 (2) *Oxford Journal of Legal Studies* 325.

## 2.1 The Nature of Insolvency

It has been widely acknowledged that the process of globalisation has caused national economies to become more open and increasingly linked globally, and one of the direct influences on this trend has been allowing international enterprises to take risks and reap the benefits of any success they have achieved.<sup>2</sup> As the World Bank has identified, “globalisation is not a single process, it proceeds as people and institutions seek profits and competitive advantage through expanding trade in goods and services and cross-border flows of financial resources and people”.<sup>3</sup> One inevitable result of this process may be a cross-border failure. The reasons that lead an international company to failure can be various, but the causes of business failure always include both internal failures and external pressures.

Regarding internal failures, the most common reason for insolvency is the failure to manage cash flows. A lack of money will stop the operation of the whole company since a healthy cash flow covers all the expenses of current operations, and provides funds for the next business cycle. Accordingly, managing cash flows requires the comprehensive ability to analyse all relevant information; failure at any stage will cause the collapse of the business. Mismanagement, another main reason for insolvency, is responsible for around a third of business insolvencies.<sup>4</sup> Managerial skills, such as developing appropriate market strategies and business expansion plans, are closely connected with the fate of the company. Apart from the internal factors, external pressures are more likely to bring unexpected failure, especially for multinational enterprises.<sup>5</sup> Changes in consumer behaviour can be unpredictable, so a business that fails to follow consumer trends will be automatically eliminated from the market. Also, changes in regulations or laws

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<sup>2</sup> Rosalind Mason, ‘Cross-border Insolvency: Where Private International Law and Insolvency Law Meet’ in Paul J. Omar (ed), *International Insolvency Law: Themes and Perspectives* (Ashgate Publishing Limited 2008), 28.

<sup>3</sup> The World Bank, *World Development Indicators 2006* (The World Bank, 2006), 311.

<sup>4</sup> Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles* (2<sup>nd</sup> edn, Cambridge University Press, 2009) 155.

<sup>5</sup> *ibid*, 161.

in foreign markets may cause extra operational costs or investment, so companies may fail to keep the expenses balanced and meet financial challenges. In the international market, the competition from local competitors can be severe since it brings costs and price advantages. Furthermore, changes in the economic environment will invariably impinge on corporate activities. The 2008 financial crisis, which started in the banking industry and influenced almost all fields of industry all over the world, maybe a good example. Therefore, for a cross-border company, because of the high amount of capital input, it will face more managerial and operational pressures from both internal and external forces.

### ***The Start of Insolvency***

The primary objective of insolvency systems is to liquidate companies that are insolvent and cannot be rescued, and to give businesses that are in financial trouble, but are economically viable, a second chance to enter the rescue process.<sup>6</sup> It is important to understand the standards that determine whether a company is in the proper circumstances to be put into insolvency. Technically, insolvency means that a business is unable to meet its financial obligations as they fall due, or also can be identified as a situation whereby a company's total liabilities exceed its total assets.<sup>7</sup> To understand this, it is necessary to distinguish liquidity issues and solvency issues. A liquidity crisis means that a company is experiencing cash-flow problems. Although in theory, its assets are greater than its debts, some assets are illiquid, and cannot meet payment requirements promptly. Liquidity reflects the relationship between liquid assets and short-term financial obligations.<sup>8</sup> The solvency crisis means the value of a company's assets cannot cover all its debts, and it illustrates

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<sup>6</sup> International Monetary Fund, 'Orderly & Effective Insolvency Procedures: Key Issues' (1999) <<http://www.imf.org/external/pubs/ft/orderly/>> accessed 20 February 2015.

<sup>7</sup> Roman Tomasic, *Insolvency Law in East Asia* (Ashgate Publishing Limited, 2006) 403.

<sup>8</sup> Julie E. Margret, 'Insolvency and Tests of Insolvency: An Analysis of the "Balance Sheet" and "Cash flow" Tests' (2002) 12(2) Australian Accounting Review 59.

the long-term calculation of a company's ability to pay.<sup>9</sup> Generally, the evaluation of whether a company satisfies the test of entry to the insolvency process will be based on consideration of both situations, which are directly reflected in the company's balance sheet and cash-flow.

### ***Balance sheet Test and Cash Flow Test***

The balance sheet test and the cash flow test are two primary tests of inability to pay debts, and they are both commonly used in insolvency laws as trigger points for formal insolvency proceedings. The former means that solvency issues have occurred and assets are insufficient to discharge liabilities. The latter is connected to liquidity issues, which means a company's liquid assets cannot cover its debts as they fall due, so the reality that the company's assets exceed its total liabilities are not met.<sup>10</sup>

There are some connections between balance sheet insolvency and cash flow insolvency. The balance sheet test is based upon an assessed valuation of the totality of assets and liabilities associated with the insolvent debtor, so it is possible that a company is cash flow insolvent but balance sheet solvent. On the other hand, if a business keeps making a loss in its business activities, balance sheet insolvency will occur once the accumulation of its loss is higher than its capital. If there are no new capital inflows, sooner or later cash flow insolvency will occur as well. Cash flow insolvency is more straightforward than balance sheet insolvency since its evidence can be proved by the cash flows records of the company.

The application of the two tests has been adopted by national laws in different ways. Some countries only apply a single test; for example, only the cash-flow test is applied to decide whether a company is insolvent according to the Australian Corporation Act and Bankruptcy Act. Most jurisdictions attempt to combine the two tests. Under the Chinese bankruptcy system, the court can

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<sup>9</sup> *ibid.*

<sup>10</sup> Ray Goode, *Principles of Corporate Insolvency Law* (3<sup>rd</sup> edn, Sweet & Maxwell, 2005) 114.

declare insolvency if one of the two conditions is satisfied:

Article 2: Where an enterprise legal person cannot pay off his debts due and his assets are not enough to pay off all the debts, OR he cannot apparently pay off his debts, the debts shall be liquidated according to the provisions of this Law.<sup>11</sup>

The first condition is clear: that it requires both cash flow insolvency and balance sheet insolvency to declare a company is entering the insolvency process. The second condition is more flexible in its application. If a debtor fails in financial management, and loses the capability of repaying all of its debts, this provides the possibility of declaring insolvency without the presence of a balance sheet test. However, the law fails to give a clear interpretation of 'apparently lacks the ability'. Professor Wang has explained that it means the debtor is not yet insolvent but it can be clearly predicted when it will not be able to pay its debts at a future specific time, based on the available financial and operational information.<sup>12</sup> The judicial interpretation issued by the Supreme Court explained that the meaning of 'inability to pay due debts' implies three conditions: the debt must have become due, the debtor must obviously lack the ability to pay the debt, and the fact of the debt not having been paid must have lasted for a long period.<sup>13</sup> The explanation provides basic requirements based on the cash flow test, but no guidance about the evaluation of overall debts and assets.

England's insolvency law treats the two tests more independently. The cash flow test has been set out under section 123 (1) (e) 'if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due', and section 123 (2) sets out the balance sheet test, but also

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<sup>11</sup> Enterprise Bankruptcy Law of the People's Republic of China 2006, Article 2 (China).

<sup>12</sup> Wang Weiguo, *The Sum and Substance of Enterprise Bankruptcy Law* (Law Press 2007).

<sup>13</sup> Notice of the Supreme People's Court on Implementing the Rules on Some Issues concerning the Application of Law to Enterprise Bankruptcy Cases pending Trial upon the Effectiveness of the Enterprise Bankruptcy Law of the People's Republic of China, the Supreme People's Court [2007] Judicial Interpretation No.81.

emphasises that the test should take into account the debtors' contingent and prospective liabilities.<sup>14</sup> Apart from these two tests, this section also includes very specific standards for showing a company's inability to pay debts: if a company fails to pay, secure or compound, to the reasonable satisfaction of the creditor, a debt more than £750 within three weeks of a written demand having been issued.<sup>15</sup>

The Supreme Court's decision confirmed that the cash flow test should consider not only debts that are immediately payable, but also debts that fall due in the reasonable future, and make a decision based on the different circumstances of cases.<sup>16</sup> A similar principle is also applied to the balance sheet test: since the article is 'far from exact', the test cannot be satisfied simply based on the company's statutory balance sheet. The court emphasised that the test needs to be decided on a case-by-case basis, and to take into account all the possible omitted information.<sup>17</sup> This point is also significant for international cases since business activities are always conducted in more than one jurisdiction. It is possible that some information cannot be timely reflected in the balance sheet. It requires the review of all relevant information and the nature of the company's business to illustrate the genuine financial position of a company.

## 2.2 The Goals of the Insolvency Law

Once a business becomes insolvent, the relationship between debtors and creditors changes dramatically, and the latter will become the residual claimants of corporate activities. Secured creditors, who can look to specific property or collateral for repayment of a debt, may exercise their right and

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<sup>14</sup> Insolvency Act 1986, s123 (1) (e), (2).

<sup>15</sup> Insolvency Act 1986, s123 (1) (a).

<sup>16</sup> *BNY Corporate Trustee Services Ltd v Eurosail* [2013] UKSC 28.

<sup>17</sup> *ibid*; also Latham & Watkins, *Eurosail- Has the Balance Been Redressed (Restructuring, Insolvency & Workout Practice, 2013)* <<https://www.lw.com/thoughtLeadership/eurosail-uk-supreme-court-insolvency>> accessed 12 March 2015

enforce their security over the debtor's assets, and along with other creditors, which may include other lenders or any entity to which a debtor owes money for services provided, may start legal proceedings to seek remedies. In this situation, the function of the insolvency laws is to govern the liquidation, or the rescue proceedings, and regulate the process of satisfying outstanding creditors' claims from the insolvent debtor's assets.<sup>18</sup> Although the insolvency systems are different in different nations, there are common characteristics and goals shared by them.

### **2.2.1 Cooperation among Creditors**

The main goal of all insolvency systems is to regulate collective actions faced by different types of creditors. When a company's financial distress becomes serious, each creditor wants to collect a debt and hold the debtor's properties or assets as soon as possible, and it is difficult to expect that they could voluntarily coordinate themselves.<sup>19</sup> The situation is perfectly understandable for individual creditors; however, the better outcomes may not be achieved if the value of a debtor's assets as a whole is higher than the sum of those assets' market prices. Thus, in the interest of all creditors, the best way is to work together to decide whether restructuring would be possible, or decide on the best way to sell the debtor's assets so as to maximise their value.<sup>20</sup> Moreover, during the cooperation, another problem is that some creditors might refuse the restructuring plans that maintain the going concern value of the business, and adhere to the plans that may be risky, but also would be

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<sup>18</sup> Susan Block-Lieb, Juraj Alexander and Evgeny Kovalenko, 'Representing the Interests of Unsecured Creditors: A Comparative Look at UNCITRAL's Legislative Guide on Insolvency Law', in Paul Omar (ed), *International Insolvency Law: Reforms and Challenges* (Ashgate 2013).

<sup>19</sup> Douglas Baird and Thomas Jackson, 'Corporate Reorganisations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy' (1984) 51 *University of Chicago Law Review* 97, 100.

<sup>20</sup> *ibid*; also The World Bank, 'Principles and Guidelines for Effective Insolvency and Creditor Rights System' (the World Bank 2001) < <http://siteresources.worldbank.org/GILD/PrinciplesAndGuidelines/20162797/Principles%20and%20Guidelines%20for%20Effective%20Insolvency%20and%20Creditor%20Rights%20Systems.pdf> > accessed 15 March 2015.

value-enhancing for them. Therefore, governing the creditors' claims and balancing the agreements and interests among different creditors is one of the main purposes of the insolvency law. To address the creditor problems, in practice, a legal specialist, called an administrator or officeholder, normally will be nominated to investigate the properties available for distribution, and manage the upcoming processes. The identification of a debtor's divisible assets is the fundamental feature of any insolvency proceedings.<sup>21</sup> Additionally, in order to satisfy all the creditors and ensure all the creditors are ranked equally, the principle of *pari passu*, which means "ranking equally", usually applies to insolvency law rules. For the purpose of orderly liquidation and fairness to all creditors, the creditors receive distribution *pro rata* based on pre-insolvency entitlements.<sup>22</sup> The rule also has been well-applied for cases with international elements as the foremost principle; many jurisdictions adopt the same treatment to foreign creditors as domestic creditors.<sup>23</sup>

### **2.2.2 Distributive Nature**

Insolvency laws always involve satisfying creditors' claims by distributing debtors' assets to them, and another main goal of the insolvency system is to resolve distributional disagreement in insolvency proceedings. In most of the situations, the creditor's claims cannot all be guaranteed; so it is necessary to have an insolvency law to regulate the distribution orders among different types of creditors. However, the insolvency laws across jurisdictions are very diverse, and the differences reflect the different political policy goals pursued by governments and policymakers.<sup>24</sup> Regarding the rules of distribution, the priority of creditors' legal rights may be ranked based on the nature of their claims. In many countries, creditors' rankings always have a certain purpose

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<sup>21</sup> Robert K. Rasmussen, 'A New Approach to Transnational Insolvencies' (1997) 19 (1) *Michigan Journal of International Law* 1.

<sup>22</sup> Rizwaan Jameel Mokal, 'Priority as Pathology: The *Pari Passu* Myth' (2001) 60 (3) *Cambridge Law Journal* 581.

<sup>23</sup> *ibid.*

<sup>24</sup> John AE Pottow, 'Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to Local Interests' (2006) 104 *Michigan Law Review* 1899, 1902–03.

in order to protect specific classes of creditors. For example, under the Mexican law, the employees' claims should be satisfied before any other kinds of creditors; but, under the US Bankruptcy Code, the secured creditors always have priority, and labour claims are categorised as unsecured creditors.<sup>25</sup> However, even though the jurisdictions provide similar priority rights for certain creditors' claims, the outcomes may still differ regarding how the distribution is received. For instance, in some states, the right of claims of employees' payment would be covered by the pension's claims, while some other jurisdictions do not support similar claims.

Furthermore, pro-creditors and pro-debtors principles play an important role in the distribution of assets.<sup>26</sup> The pro-debtors approach engages in increasing the possibility of restructuring insolvent companies since it can avoid the loss of job opportunities and negative influences on suppliers. On the contrary, a pro-creditors regime aims to protect the creditor's contractual rights and focus on distributing assets at greater value. Such rules affect the distribution among creditors significantly, and are also essential elements for governments and lawmakers to consider in deciding insolvency law rules.<sup>27</sup> So this can be another reason why insolvency regulations diverge considerably from country to country.

### **2.2.3 Encouraging Market Stability**

Modern insolvency systems seek to encourage commercial morality and integrity.<sup>28</sup> Because of the relationship among different types of enterprises are becoming closer, and one insolvent company might lead to a negative

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<sup>25</sup> Mexico: Law of Commercial Insolvency (Ley de Concursos Mercantiles), Article 224 (1); the US: 11 U.S. Code § 507 a (1) (2).

<sup>26</sup> Sefa M. Franken, 'Cross-Border Insolvency Law: A Comparative Institutional Analysis' (2014) *Oxford Journal of Legal Studies* 97, 108.

<sup>27</sup> *ibid.*

<sup>28</sup> Joseph Spooner, 'Recalling the public interest in personal insolvency law: a note on Professor Fletcher's foresight' (2015) 3 (29) *Nottingham Insolvency and Business Law eJournal* 537, 540; Ian. Fletcher, 'Bankruptcy Law Reform: The Interim Report of the Cork Committee, and the Department of Trade Green Paper' (1981) 44 *The Modern Law Review* 77.

chain reaction among other related companies, the insolvency laws have been paying more attention to business rescue and reorganisation. Such a trend has recognised that the economic benefit of the preservation of a company is an equally important consideration for the maximisation of creditor returns, and the culture emphasises a focus on the possibilities of an insolvent company's future development rather than its quick, effective liquidation.<sup>29</sup> As the UNCITRAL's Working Group stated in its report, reorganisation offers an opportunity to keep all the essential parts of the business together rather than dispose of them in fragments, which may achieve better value than before.<sup>30</sup>

A domestic insolvency system has a close connection with its economic environment, so in order to contribute to economic growth, the insolvency law needs to maximise the value of the firm by putting its assets to the highest-valued use.<sup>31</sup> For this purpose, an insolvency law should be effective in both *ex-ante* and *ex-post* perspectives. From the *ex-ante* side, the law should promote commercial moralities among company managers, shareholders and creditors, and guide them to keep the business out of insolvency.<sup>32</sup> The managers should do their best to manage the operation to avoid financial distress, or strict punishment may be enforced. In some insolvency procedures, the managers could be replaced by court-appointed officials in insolvency proceedings, or punished by being held responsible for the firm's debts if the financial problem has been caused by their negligence. Some incentives in the laws to encourage shareholders and creditors to actively monitor the business activities can be effective in avoiding business collapse as well. Efficient regulation could create as few insolvency cases as possible by strictly regulating the business launch process, but many insolvency

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<sup>29</sup> World Bank, 'Principles and Guidelines for Effective Insolvency and Creditor Rights Systems' (2001) 53.

<sup>30</sup> United Nation Commission for International Trade Law "UNCITRAL", *Legislative Guide on Insolvency Law* (2005) <[http://www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf)> accessed 20 February 2015.

<sup>31</sup> Sarah Paterson, 'Rethinking the Role of the Law of Corporate Distress in the Twenty-First Century' (Society and Economy Working Papers, LSE Law 2014) <[http://www.lse.ac.uk/collections/law/wps/WPS2014-27\\_Paterson.pdf](http://www.lse.ac.uk/collections/law/wps/WPS2014-27_Paterson.pdf)> accessed 02 March 2015.

<sup>32</sup> Sefa M. Franken (n 26), 105-106.

regulations have ignored such a function since it is difficult to evaluate *ex-ante* empirically.<sup>33</sup> For *ex-post* effectiveness, it can be easily evaluated by assessing the expenses of the whole process, and the payments outcomes.

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In the 21<sup>st</sup> century, insolvency policies play a more vital role in commercial society. For instance, if the legal provisions do not include clear regulations about the priority of distribution among various creditors, it would directly affect the willingness of investors to lend money to new enterprises. As a result, market confidence and business dynamism would be damaged. So it is obvious insolvency issues have significant influences not only on the shareholders related to the debtor, but on the development of the national economy at both micro and macro levels. As the number of multinational enterprises and their impacts grow, this legal domain has been burdened with political and commercial demands.<sup>35</sup> Therefore, a well-established insolvency system is important for a complete legal system, and the good commercial order of a state.

#### **2.2.4 The Corporate Rescue Culture**

Traditionally, liquidation or winding up is the last resort of an insolvent company as it is a collective process leading to the end of a company's existence.<sup>36</sup> The process of liquidation always involves a court-appointed liquidator to collect and realise the assets of the insolvent debtors, and distribute the assets to creditors based on their legal priority laid down by the insolvency laws. However, the insolvency culture has been changing following the development of business and legal cultures, and corporate rescue has emerged under modern insolvency law. It should be noted that the definition

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<sup>33</sup> *ibid*; also Priit Manavald, 'Economic Crisis and the Effectiveness of Insolvency Regulation' (2010) 17 *Juridical International Law Review* 207.

<sup>34</sup> *ibid*.

<sup>35</sup> Christoph G. Paulus, 'Global Insolvency Law and the Role of Multinational Institutions' (2007) 32 *BROOK. J. INT.L L.* 755.

<sup>36</sup> Philip R. Wood, *Principles of International Insolvency* (2<sup>nd</sup> edn, Volume 1, Sweet & Maxwell 2007).

of corporate rescue here can be very broad. Rescuing a company does not mean that the company should be kept at its current operational level; so if a company has been proved to be inefficient and not economically viable, the normal winding-up procedure should be initiated.<sup>37</sup>

In order to decide whether a company can be rescued, there are two concepts that should be clarified. The difference between financial distress and economic distress should be clarified.<sup>38</sup> A company in financial distress usually means that it has cash flow issues. As mentioned above, a cash flow problem is related to the liquidity situation of the company. If and when a company cannot meet its current liabilities may be caused by short-term dislocations in the market. Temporary illiquidity and large debt repayment can be normal in the business life cycle, and it does not mean the company is not economically viable.<sup>39</sup> This kind of situation is the main reason for having corporate rescue procedures, the purpose of which is to help those companies survive their financial troubles and recover to operate healthily. Economic distress is the situation that arises when “the net present worth of the troubled company’s business as a going concern is less than the value of the assets broken up and sold separately.”<sup>40</sup> Those companies are not eligible for rescue.

Compared to the dissolution of an insolvent company, trying to rescue one may accomplish better results not only for creditors and shareholders, but also for social and economic interests.<sup>41</sup> For instance, some work placements can be sustained, and negative influences on relevant suppliers and customers

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<sup>37</sup> The Insolvency Service, ‘A Review of Company Rescue and Business Reconstruction Mechanisms: Report by the Review Group’ (London: HMSO 2000), para 24.

<sup>38</sup> General discussion: Gregor Andrade and Steven N. Kaplan, ‘How Costly is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions that Became Distressed’ (1998) 53 *Journal of Finance* 1443.

<sup>39</sup> Gerard McCormack, *Corporate Rescue Law- An Anglo American Perspective* (Edward Elgar Publishing, 2008), 9-10.

<sup>40</sup> Riz Mokal, ‘Administrative Receivership and Administration— An Analysis’ (2004) 57 *Current Legal Problems* 355, 358.

<sup>41</sup> Vanessa Finch and David Milman, *Corporate Insolvency Law: Perspectives and Principles* (3<sup>rd</sup> edn, Cambridge University Press 2017) 197.

can be avoided as well.<sup>42</sup> Although the development of a corporate rescue culture has not been operating long, it has been defined as a “major intervention necessary to avert eventually failure of the company”,<sup>43</sup> and accepted worldwide. For instance, under the UK insolvency regime, administrations and the Company Voluntary Arrangement (CVA) have a good history, and have been significant in facilitating company rescue plans, the primary purposes of those procedures being to rescue the company as a going concern, and achieve better result for the creditors as a whole than would have been likely if the company had been wound up.<sup>44</sup> Chapter 11 under the US Code is there to give debtors legal protection and an opportunity to reorganise; it also possibly provides creditors better value for their debts.<sup>45</sup>

A well-established insolvency law system for the modern business market should have the ability to eliminate hopeless enterprises and guide commercially viable businesses to gain a second chance, especially the businesses that are capable of making a useful contribution to the economic life of the country.<sup>46</sup> Considering the broader picture, the insolvency of international business can affect more than creditors, employees and shareholders, it can even affect the domestic and global market environment. Therefore, international organisations have explicitly pointed out that corporate rescue should be a main principle and focus of insolvency reforms.<sup>47</sup>

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<sup>42</sup> Riz Mokal (n 38), 358.

<sup>43</sup> Alice Belcher, *Corporate Rescue: A Conceptual Approach to Insolvency Law* (Sweet & Maxwell, London, 1997), 36.

<sup>44</sup> Insolvency Act 1986, Schedule B1, 3 (1).

<sup>45</sup> *Canadian Pacific Forest Products Ltd v JD Irving Ltd* (1995) 66 F 3d 1436, 1442; see discussion: Gerard McCormack (n 39), 4.

<sup>46</sup> Muir Hunter, ‘The Nature and Function of a Rescue Culture’ (1999) 04 *Com. L.J.* 426, 434.

<sup>47</sup> International Monetary Fund, ‘Orderly & Effective Insolvency Procedures: Key Issues’ (1999).

## 2.3 The Nature of Cross-Border Insolvency

With the growing convergence of economic activities around the world, the likelihood is that any given insolvency situation will not be restricted to only one state. Therefore, for a country that wants to attract more foreign direct or indirect investment to boost its domestic economy, it is very important to have a legal system regulating the failure of foreign businesses.<sup>48</sup> The next part will focus on the basic issues and theories of cross-border insolvency.

### 2.3.1 The Meaning of Cross-Border Insolvency

The starting point for explaining the meaning of cross-border insolvency is that it is a by-product of the globalisation of business activities.<sup>49</sup> Legal scholars have tried to give clear explanations based on the nature of the issues. Goode clarified that terms such as 'international insolvency' or 'cross-border insolvency' do not have specific meanings, but the situations are generally linked with insolvencies which arise from cross-border trading, or where insolvency laws of two or more jurisdictions are possibly involved.<sup>50</sup> Westbrook describes "transnational insolvency is the management of the general financial default of a multinational enterprise".<sup>51</sup> The definition from UNCITRAL is more detailed, stating that cross-border insolvency refers to cases 'where the insolvent debtor has assets in more than one state or where some of the creditors of the debtor are not from the state where the insolvency proceedings are taking place'.<sup>52</sup> Some commentators have also discussed the nature of international insolvency under the content of the private

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<sup>48</sup> Sumant Batra, 'Insolvency Laws in South Asia: Recent Trends and Developments' (the Fifth Forum for Asian Insolvency Reform, Beijing 2006).

<sup>49</sup> Bob Wessel, 'Cross border Insolvency Law', Kluwer Law International 2007, article preview < <http://www.chasecambria.com/site/journal/article.php?id=281> > accessed 12 March 2017.

<sup>50</sup> Sir Roy Goode, *Principles of Corporate Insolvency Law* (4<sup>th</sup> edn, Sweet & Maxwell 2011) 781; Ian Fletcher, *Insolvency in Private International Law* (2<sup>nd</sup> edn, Oxford University Press 2005) 3-5.

<sup>51</sup> Jay L. Westbrook, 'A Global Solution to Multinational Default' (2000) 98 *Michigan Law Review* 2276, 2278.

<sup>52</sup> UNCITRAL, *Legislative Guide on Insolvency Law*, 307.

international law, which points out that the international insolvency laws need to be multifunctional, concerning problems like conflict of law rules, procedural and substantive standards.<sup>53</sup>

However, it should be noted that cross-border insolvency cannot be merely treated as an extension of the legal domain of insolvency laws.<sup>54</sup> It is an independent issue that involves the insolvency laws of two or more countries. Since this area is a by-product of business globalisation, the law should be designed and specialised taking an international point of view. Another reason is that international insolvency is more complicated than domestic cases. Cross-border insolvency laws not only need to solve similar issues faced by domestic laws, but they also need to address problems such as jurisdiction disputes or coordinating the interests of local and foreign creditors. Furthermore, as solving an international case requires the cooperation of local courts and insolvency practitioners among different nations, the procedural and material norms could be essential. Therefore, the laws for cross-border insolvency require global considerations and a more comprehensive system.

### **2.3.2 Three Fundamental Issues**

The main issue of cross-border insolvency is caused by the significant differences among national insolvency laws.<sup>55</sup> Due to various political systems and social and commercial development, the divergence can be reflected in many problems. Furthermore, most domestic insolvency systems cannot keep pace with the continuing development of international trade and investment, which may lead to international inconsistency in solving cross-border insolvency.<sup>56</sup> Overall, in order to overcome the differences among national insolvency laws, private international law issues can be applied to identify three fundamental issues for solving cross-border insolvency: choice

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<sup>53</sup> Bob Wessels, *International Insolvency Law* (Volume X, Kluwer 2006) 1.

<sup>54</sup> Chindar Teo, 'The Cross-Border Insolvency of International Banks' (PhD Thesis, Victoria University 2013) 95.

<sup>55</sup> Bob Wessels, Bruce A. Markell and Jason J. Kilborn, *International Cooperation in Bankruptcy and Insolvency Matters* (Oxford University Press 2009), 200.

<sup>56</sup> *ibid.*

of forum, choice of law, and the recognition and enforcement of decisions from foreign insolvency proceedings.<sup>57</sup>

### Choice of Forum

Firstly, the issue of jurisdiction: a court needs to decide whether the international matter can be or will be heard.<sup>58</sup> This question is important because creditors located in different jurisdictions may file insolvency petitions in front of different courts, or proceedings against the same debtor already exists. It requires the court to decide the jurisdiction as soon as possible to avoid causing confusion to both creditors and debtor. Currently, international regimes are trying to address this problem by using the concept of centre of main interests (COMI), which means that the courts of the state that the debtors were incorporated, or its principal places of business, will have the jurisdiction to hear the case. The purpose of the concept was to provide a unified standard for the choice of forum issue, but the application of COMI has caused serious discussions and issues in practice. The problem will be discussed in detail later in this thesis.

### Choice of Law

The second inherent issue is the choice of law – to decide which law will be used to govern the whole proceedings. For multinational insolvency, the rule of choice of law is about predictability and certainty, which is the essential knowledge that debtors or creditors need to know before and after the commencement of any insolvency proceedings.<sup>59</sup> It means that an effective law for cross-border insolvency, following either private international or international regimes, should permit the creditors to anticipate the applicable law which will control the whole proceedings. It seems that the ‘home country rule’, which means the law of the company’s home country, or principle asset

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<sup>57</sup> Ian Fletcher (n 48), 6: three questions: “which jurisdictions may insolvency proceedings be opened? What country’s rules of law should be applied with respect to those aspects of the case in which elements of diversity are present? What international effects will be accorded to proceedings conducted at a particular forum?”

<sup>58</sup> *ibid.*

<sup>59</sup> Jay L. Westbrook, ‘Theory and Pragmatism in Global Insolvencies: Choice of Law and Choice of Forum’ (1991) 65 *Am. Bankr. L.J.* 457, 469.

country, should be applied is the well-recognised principle for this problem since it could provide the most accurate and reliable prediction for the applicable law in advance.<sup>60</sup> However, the main issue is about the definition of 'home country'. Country of incorporation can be easily identified, but such a standard might not always reflect the real situation of multinational enterprises, which means the real "home" should mirror the company's principle centre, and be consistent with creditors' expectations regarding the location and applicable law of a possible insolvency process.<sup>61</sup>

From the point of view of individual countries, the application of their insolvency law on international cases is obviously the preferred choice. Firstly, as the local assets and creditors would not be governed by foreign laws, national sovereignty can be protected, especially for some jurisdictions that have not built a valid insolvency system. Additionally, holding control of the insolvency proceedings can increase the possibility of reaching an outcome that is more beneficial to local interests, such as the protection of local creditors and an increase in tax revenues to the state. Then, using one's own law is more efficient and economical. The whole proceedings would be faster because the learning cost and time needed to be familiar with foreign insolvency law that may be applied can be avoided. Franken provided an explanation about this issue from an economic perspective which might be more direct to the nature of the problem.<sup>62</sup> The analysis illustrated that legal choices for cross-border insolvency depend on the extent to which the legal system increases economic benefits from cross-border trading activities.<sup>63</sup> Some countries' economic growth mainly depends on export and import business activities, and drawing more foreign direct and indirect investment into the domestic market is the main tool to stimulate economic development;

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<sup>60</sup> *ibid*, 470, home-country rule that permits creditors to anticipate that one law will control most aspects of a default will greatly benefit predictability and contribute to Transactional Gain".

<sup>61</sup> Irit Mevorach, 'Forum shopping in times of crisis: a directors' duties perspective' (2013) 10 (4) *European Company and Financial Law Review* 523, 540.

<sup>62</sup> Sefa M. Franken, 'Cross-Border Insolvency Law: A Comparative Institutional Analysis' (2014) 31 (1) *Oxford J Legal Studies* 97.

<sup>63</sup> *ibid*, 111-114.

in other words, the sum of international trading is a big part of their GDP. Therefore, such countries prefer to apply their own law to achieve results that protect their interests. It can be said that, from either political or economic considerations, own insolvency law is always the preferred choice.

### Recognition and Enforcement

Finally, the problem of recognition and enforcement of foreign judgments directly influences the outcomes of insolvency proceedings. This question is the most international part of the whole cross-border insolvency process as it deals with problems like how to work with the foreign courts that have issued the judgment, or what effects the judgement will have. A cross-border insolvency system cannot be successful without a comprehensive process to deal with the recognition and enforcement of foreign orders. Particularly, this is the part that requests international cooperation since there will be situations such that foreign representatives might require control of the local assets belonging to the insolvent debtor, or the content of a foreign judgment may conflict with the local laws. In particular, the most difficult issue behind this question is finding the balance between protecting local interests and assisting the foreign proceedings.

Although it is a well-accepted concept that cooperation among different courts of jurisdiction is the best way to solve international insolvency cases,<sup>64</sup> details about how to achieve mutual agreement on this problem remain unclear. The principle of comity has been suggested by international regimes and organisations. Based on the interpretation of the US Supreme Court explanation, the legal meaning of comity is neither an absolute obligation nor a courtesy nor goodwill, so it should be seen as the recognition by a state to allow legislative, executive or judicial acts of another nation to be conducted

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<sup>64</sup> Encouraging cooperation among different countries in cross-border insolvency cases is one of the main features of the UNCITRAL Model Law, *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation*, 19-20. Further discussion of court communication and cooperation in Jay L. Westbrook, 'International Judicial Negotiation' (2003) 38 *Texas International Law Journal* 567.

within its territory for the purpose of international duty and convenience.<sup>65</sup> So, the decision still needs to be made according to private international laws, and the question is to what extent the local laws and courts should cooperate with foreign proceedings. Under most legal systems, the principle usually is that the comity can be granted if foreign decisions are not violating the domestic laws and public policies; however, the application of the principle cannot be that straightforward.

A recently-decided common law case can be a good example to illustrate the issue. The main issue of the *Singularis* case was about the scope of common law powers to assist foreign insolvency proceedings.<sup>66</sup> In this case, the Cayman Islands court, which was the court conducting the winding up, issued an order requiring certain assets and financial information from the debtor, based on the Company Act in Bermuda. When the liquidator from the Cayman court tried to enforce the order in Bermuda, the court rejected the application on the grounds that the equivalent order would not be issued and applied by the court where the foreign proceedings were being conducted. The majority of judges agreed that the common law had the power to cooperate and assist foreign insolvency proceedings, but the power was limited to not only local law and public policy, but also the foreign courts' statutory powers. Under such circumstances, even the foreign liquidator had been recognised; the foreign judgment could not be enforced. Therefore, under common law, there are strict limitations relating to international assistance.

The case reflects some essential questions about cross-border insolvency. The first one is the identification of assets. Since the locations of multinational companies' assets can be very dispersed, the investigation of that information can be difficult and time-consuming without the assistance of local courts where the insolvent debtors' assets are located, which will directly influence the efficiency of the whole proceedings. More importantly, it may increase the

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<sup>65</sup> *Hilton v. Guyot*, 159 U.S. 113, 164 (1895); Donald Earl Childress III, 'Comity as Conflict: Resituating International Comity as Conflict of Laws' (2010) 44 *UC Davis Law Review* 13.

<sup>66</sup> *Singularis Holdings Ltd v Price Waterhouse Coopers* [2014] UKPC, para 36.

possibility that debtors will hide certain assets or of forum shopping. Secondly, another essential issue is the power of foreign insolvency representatives. As mentioned above, states prefer to use their own law to regulate international cases. Therefore, on what conditions the foreign representatives can take over and administer local assets, and what they can do to those assets, are all important issues under insolvency law. Moreover, the creditors are also located in different jurisdictions, and so the legal position of creditors from abroad is also an issue; which nation's distribution rules will be used to satisfy all creditors' claims can also be vital for the result. So communication and negotiation can be essential for international cases. Other practical issues include how documents and evidence need to be examined for recognition, or how witnesses are to be examined if the relevant parties are in different foreign countries. All these questions need to be solved based on a unified regime that can allow all countries to work together.

## **2.4 Theories of Regulating Cross-border Insolvency**

Before discussing the practical solutions to multinational insolvency, the conceptual backgrounds which offer a foundation for solving this specific matter will be examined. Traditionally, there are two theories within this area: universalism and territorialism.<sup>67</sup> The main differences between the two involve two aspects. First, they are related to the number of countries or courts which have the jurisdiction to open the insolvency proceedings against a debtor, and the second aspect is the different multinational effects of insolvency proceedings under each concept.<sup>68</sup> However, according to the practical experiences of applying those two systems, there are some revised or modified systems which have been developed based on those two aspects. Thus, in this part, apart from the discussion of the basic concepts, some

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<sup>67</sup> Lynn M. LoPuck, 'Cooperation in International Bankruptcy: A Post-Universalist Approach' (1999) *Cornell Law Review* 696.

<sup>68</sup> Edward S. Adams and Jason K. Fincke, 'Coordinating Cross-Border Bankruptcy: How Territorialism Saves Universalism' (2009) 15 *Columbia Journal of European Law* 43, 47-50.

influential modified concepts also will be analysed.

It is worth noting that the goals of the two approaches are similar.<sup>69</sup> Fairness is the main objective, and the point is that no matter where the creditors are located, they should be treated equally. Also, the expenses and time should be minimised, the possible conflicts between different countries should also be minimalised, and the interests of both debtors and creditors all need to be considered. Overall, increasing the economic efficiency and predictability of the insolvency proceedings is the aim of both systems.

### **2.4.1 Universalism and Territorialism**

Pure universalism means that a single set of insolvency proceedings should exist to deal with the worldwide assets of the debtor, and this concept treats the world as a single international market that needs one market-symmetrical law to govern the insolvency process.<sup>70</sup> Accordingly, the home country will have jurisdiction to collect, administer and distribute all the assets no matter where the assets are located, and creditors from different locations have equal rights to submit claims and get paid. Ancillary proceedings might exist since the assets are located in different jurisdictions, but those separate proceedings cannot make independent distribution decisions since their sole purpose is to facilitate and assist the principal proceeding under the law of the debtor's home country. There is thus the need for international cooperation and communication to manage the worldwide assets. The idea of the universalists is that the regulations governing multinational insolvencies should reflect the borderless nature of the global market, so a global market

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<sup>69</sup> Federico M. Mucciarelli, 'Not just Efficiency: Insolvency Law in the EU and its Political Dimension' (2013) 14 (02) *European Business Organization Law Review* 175.

<sup>70</sup> Lynn M. LoPuck (n 64), 704; Sefa M. Franken, 'Three Principles of Transnational Corporate Bankruptcy Law: A Review' (2004) 017 TILEC Discussion Paper 1.

requires a global bankruptcy law.<sup>71</sup>

The opposite face of universalism is territorialism, which implies a system whereby each country controls the debtor's assets located within their territory, and recognises other countries' rights to do the same. In other words, each of the insolvency courts would assume jurisdiction over assets within its country's borders, and then make a decision whether to join the international reorganisation or liquidation based on local laws. This approach guarantees that each state's own distributive rules and policies will govern the administration and distribution of local assets. Under this system, creditors will have to commence several separate insolvency proceedings in each jurisdiction where the particular assets are located; problems such as choice of forum and choice of law are only connected to the location of those assets.<sup>72</sup> Supporters of territorialism claim that only such a system can provide simplified solutions for chaotic cross-border cases, and a reliable prediction for creditors in terms of jurisdictions or applicable law, not like universalism, which may cause confusion about those issues.<sup>73</sup>

Theoretically, the two systems are built on different premises. While universalism pays more attention to economic efficiency, national sovereignty and the considerations of protecting local interests are the political motives of territorialism.<sup>74</sup> Convenience is one of the claimed advantages under universalism. A single forum controls all the proceedings and assets, so the international restructuring or sale of businesses would be more efficient and easier.<sup>75</sup> Debtors and creditors would only need to deal with one insolvency representative. However, the problem could be that the creditors in various jurisdictions may not be informed in time, and language barriers may put

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<sup>71</sup> Donald S Bernstein and others, 'Recognition and Comity in Cross-border Insolvency Proceedings' in Donald S Bernstein (ed), *The International Insolvency Review* (Law Business Research Ltd 2013), 1-2.

<sup>72</sup> Ksenia V. Proskurshenko, 'Chapter 15 Cross Border Insolvency: Is it True to its Universalism Aspirations?' (2005) *Rutgers Business Law Journal* 96.

<sup>73</sup> Lynn M LoPucki, 'Universalism Unravels' (2005) 79 *Am. Bankr. L.J.* 143.

<sup>74</sup> John A. E. Pottow (n 24), 1900-01.

<sup>75</sup> Andrew T. Guzman, 'International Bankruptcy: In Defense of Universalism' (2000) 98 *Michigan Law Review* 2177, 2179; Lynn M. LoPuck (n 67), 706-708.

foreign creditors in a disadvantageous position since they are forced to file claims in another jurisdiction. Regarding this point, territorialism may be more predictable for creditors since the only factor which matters is the location of assets; but, without an appropriate mechanism, worldwide individual proceedings would make international procedures like reorganisation very difficult. Furthermore, the cost of litigation is relatively inexpensive under a single set of proceedings as the number of proceedings is reduced, and the duplicated expenses can be avoided.<sup>76</sup> More importantly, it is argued that the value of the debtor's assets will be maximised as a whole, which is better for the interests of both creditors and debtors.<sup>77</sup>

In a system of territorial proceedings, the values will be limited to the local assets, and the sum of values of an individual asset is likely to be diminished. From the perspective of fairness, creditors are likely to be treated more equally under universalism as the distribution priorities will be ranked by classes among the whole pool of creditors.<sup>78</sup> Another advantage of territorialism is that the legal conflicts among involved nations will be avoided while the unified system requires cooperation and compromises; nevertheless, national processes are easily being over-protective for local interests and discriminate against foreign creditors.<sup>79</sup>

The ultimate benefit of universalism is to increase global efficiencies.<sup>80</sup> Over the years, the concept of universalism, at least as a general theory, have been recognised for solving international insolvency issues. However, a universalism system in practice can only be accomplished under ideal conditions, and it has been accused of ignoring and underestimating the

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<sup>76</sup> *ibid.*

<sup>77</sup> *ibid.*

<sup>78</sup> *ibid.*

<sup>79</sup> *ibid.*; Andrew B. Dawson, 'The Problem of Local Methods in Cross-Border Insolvencies' (2015) 12 (1) *Berkeley Business Law Journal* 46.

<sup>80</sup> John J. Chung, 'The New Chapter 15 of the Bankruptcy Code: A Step toward Erosion of National Sovereignty' (2006) 27 *Northwestern Journal of International Law & Business* 89, 95.

importance of issues like choice of forum and choice of law.<sup>81</sup> The operation of universalism needs a unified system for deciding which jurisdiction will have the power to conduct the universal insolvency proceedings and relevant matters; but without well-recognised international treaties or conventions, such a uniform standard is difficult to build. In practice, the different interpretations of the idea of a 'centre of main interests' have proved how complicated the issues could be. Therefore, universalists have accepted that the approach to achieving universalism has to be pragmatic and realistic; as professor Westbrook described it: "The idea of universalism is of a single primary bankruptcy proceeding in the debtor's home country, with courts elsewhere acting in an ancillary or supportive role to the primary court, resulting in unitary administration of assets under on bankruptcy law. Because that result would require sophisticated international agreements, the ideal remains some distance away."<sup>82</sup>

#### **2.4.2 Modified Universalism**

Modified universalism was developed as a pragmatic approach and first baby step to achieving universalism; it embraces the fundamental ideas of pure universalism, but respects that individual states may only unilaterally control its laws and territory.<sup>83</sup> Thus, modified universalism accepts multinational insolvency should be governed under the laws and by the court of the debtors' home country, and other local courts where such debtor's assets are located could open secondary proceedings and have 'the discretion to evaluate the fairness of the home country procedures and to protect the interest of local creditors.'<sup>84</sup> Another important feature is that cooperation among domestic

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<sup>81</sup> Lucian Arye Bebchuk and Andrew T. Guzman, 'An Economic Analysis of Transnational Bankruptcies' (1999) 42 *J.L. & Econ.* 7759.

<sup>82</sup> Jay L. Westbrook, 'National Regulation of Multinational Default', in Mario Monti et al (eds.) *Economic Law and Justice in Times of Globalisation* (Nomos Verlagsgesellschaft, 2007) 778-779.

<sup>83</sup> Jay L. Westbrook, 'Chapter 15 at Last' (2005) 79 *Am. Bankr. L.J.* 713, 716.

<sup>84</sup> *In re Maxwell Communication Corp'n* (1994) 170 BR 800 (Bankr SDNY); Kent Anderson, 'The Cross-Border Insolvency Paradigm: A Defence of the Modified Universal Approach Considering the Japanese Experience' (2000) 21 (4) *Journal of International Economic Law* 679, 690.

courts is encouraged to achieve an effective and ideal result.<sup>85</sup>

Modified universalism seems to be more feasible by mixing the features of two different regimes together, which means the solution might accomplish not only certain efficiencies that universalism has proposed, but also protection of local interests.<sup>86</sup> One of the advantages is that it provides flexibility to deal with foreign assets, which can be the main feature of territorialism; moreover, it also maintains most of the features of pure universalism, such as the influence on the main proceedings of holding them in the court of the home country, so that the highest efficiencies can still be achieved.<sup>87</sup> Under this system, the expenses can be higher than the original approach, but the duplicative costs can be avoided by limiting the power of the court which opens the proceedings other than the “home country” proceedings. Another reason people support the modified approach is that it reduces political concerns by protecting the sovereignty of a nation.<sup>88</sup> The ancillary court has the power to use its own national law to decide whether to cooperate with the foreign court. In this way, each state can make decisions by assessing the situation of each case, not unconditionally accept the foreign judgment.<sup>89</sup> Because of the flexibility, the approach can be more acceptable to countries with different legal systems, and more workable in the real world. With the fact that international regimes, including the European Union and the UNCITRAL, have adopted it, the development of modified universalism seems to have settled the long-running debate between universalism and territorialism.<sup>90</sup>

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<sup>85</sup> Adrian Walters, ‘Modified Universalisms & the Role of Local Legal Culture in the Making of Cross-Border Insolvency Law’ (2017) *American Bankruptcy Law Journal* [forthcoming] <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3084117](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3084117)> accessed 12 March 2018.

<sup>86</sup> Kent Anderson (n 84), 690-691.

<sup>87</sup> *ibid*; Lynn M. LoPuck (n 67), 728.

<sup>88</sup> *ibid*.

<sup>89</sup> UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, 45-46.

<sup>90</sup> Sandeep Gopalan and Michael Guihot, ‘Recognition and Enforcement in Cross-Border Insolvency Law: A Proposal for Judicial Gap-Filling’ (2015) *Vanderbilt Journal of Transnational Law* 1125.

### 2.4.3 Modified Universalism and National Laws

In practice, apart from the international regimes for cross-border insolvency, some jurisdictions have good histories of applying universalism or modified universalism to address failures of international businesses.

**The United States:** In the United States, the Bankruptcy Code has broad winding up jurisdiction over international companies, which could be exercised over any legal persons who have a domicile, or place of business, or property in the United States.<sup>91</sup> Even if just a single bank account has been opened in a US bank, it could form a sufficient jurisdictional connection. Thus, the law gives courts the power to wind up foreign incorporated companies despite the absence of principle insolvency proceedings in the jurisdiction of the home country. Beside the jurisdiction, the provisions about automatic stay show more universal attempts. Under the code, once the insolvency case is filed in the courts, the automatic stay will be applied to creditors, and any action to obtain assets or collect a debt from the insolvent debtor should be prohibited.<sup>92</sup> Creditors will be punished if they continue their actions against the debtor, whether in the United States or overseas.

Moreover, assisting foreign proceedings for solving cross-border insolvency also had a good history under US law. Section 304 of the Bankruptcy Code, which has been replaced by Chapter 15 adopting the UNCITRAL Model Law,<sup>93</sup> was the main source for the US courts dealing with insolvency cases with international elements. It gave the bankruptcy court broad and flexible authority to grant relief to assist foreign bankruptcy courts in the company's home jurisdiction.<sup>94</sup> Section 304 was enacted in 1978, and the major purpose was to "provide a statutory mechanism through which the United States courts

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<sup>91</sup> The U.S. Code Title 11: § 109 Who may be a debtor.

<sup>92</sup> The U.S. Code Title 11: § 362: Automatic Stay.

<sup>93</sup> The U.S. Code Title 11: § 304: Cases ancillary to foreign proceedings (repealed).

<sup>94</sup> *ibid*; see also Elizabeth G. Palmer, 'A Modern Application of Section 304(c) of the Bankruptcy Code: In re Gercke' (1991) 16 (3) *North Carolina Journal of International Law and Commercial Regulation* 657, 662.

may defer to or facilitate foreign insolvency proceedings”.<sup>95</sup> The general goals of section 304 and chapter 15 are similar, but a main difference between the two is that the language and application of section 304 were primarily discretionary.<sup>96</sup> The section only stated that the court “may” grant relief, whereas chapter 15 applies mandatory rules, such as “foreign proceedings shall be recognised”, if the case satisfies certain conditions listed in the chapter.<sup>97</sup>

Furthermore, section 304 allowed the foreign representative to commence ancillary in the US bankruptcy court for the purpose of aiding foreign proceedings. This section shared some common factors with modified universalism. A foreign proceeding under the definition of section 304 was a “proceeding in a foreign country in which the debtor’s domicile, residence, principal place of business or principal assets were located at the commencement of such proceeding”. The definition agreed with universalism regarding how the main principle proceeding should be commenced. Additionally, section 304 also gives the courts discretion to grant appropriate relief to assist foreign representatives. Thus, the relief granted could be tailored to fit the circumstances of particular cases, and the foreign representative could also apply for additional relief if it was necessary. Therefore, it seems that section 304 applied the “modified universalism” approach to cross-border insolvency: affording maximum flexibility and assistance to a foreign insolvency proceeding, while safeguarding certain fundamental rights of local claimants.<sup>98</sup>

**The United Kingdom:** The cross-border insolvency law in the UK is more complicated than the US. While chapter 15 is the only source for solving international insolvency issues, there are four regimes under the UK’s legal system. The European Regulation is applied when the COMI of the debtor is

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<sup>95</sup> Lynette C. Kelly, ‘Section 304 of the US Bankruptcy Code: Current Developments’ (2004) 1 (6) *International Corporate Rescue* 336.

<sup>96</sup> The U.S. Code Title 11: § 304 (b); John J. Chung (n 80), 99.

<sup>97</sup> *ibid*; The U.S. Code Title 11: § 1517 (b).

<sup>98</sup> *ibid*; Jay Lawrence Westbrook, ‘The Lessons of Maxwell Communication’ (1996) 64 (6) *Fordham Law Review* 2531, 2533.

located within one of the member states. Section 426 of the Insolvency Act 1986 only applies to proceedings from related jurisdictions or designated countries specified under this section.<sup>99</sup> For other countries, the Cross-Border Insolvency Regulation, which enacted the UNCITRAL Model Law, is applied.<sup>100</sup> Additionally, the common law principles on international insolvency operate in parallel with the statutory regime, which has illustrated the existence of more influences on the development of universalism under English law. Generally, if the foreign insolvency proceeding is opened by the court where the debtor has a centre of main interests or its genuine incorporated location, the English courts would probably recognise the extraterritorial effects of the foreign proceedings. The common law principle shares a strong connection with modified universalism promoted by the Model Law system, which provides that English courts should, subject to public policy, cooperate with the courts in the country of the principal proceedings to ensure that the distribution process is conducted under a single system.<sup>101</sup> Case laws have illustrated that most UK judges support modified universalism, and believe that international cooperation is the desired approach for solving cross-border insolvency.<sup>102</sup>

However, since modified universalism has not been codified or formalised as a unified concept, its effects and interpretation have to depend on the courts and judges at the national level.<sup>103</sup> In practice, cases from enacting countries have demonstrated the difficulties caused by the different understandings of modified universalism. In the UK, according to the Supreme Court case *Robin v Eurofinance*, a foreign insolvency judgment should not be enforceable in the UK if the particular relief the foreign representative seeks would not be granted

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<sup>99</sup> Insolvency Act 1986, Section 426; see general discussion about this section in Adrian Walters (n 85).

<sup>100</sup> Cross-Border Insolvency Regulation 2006.

<sup>101</sup> *McGrath v Riddell* [2008] UKHL 21, para 30.

<sup>102</sup> Lord Neuberger, 'The Supreme Court, the Privy Council and International Insolvency' (Keynote Speech to the International Insolvency Institute Annual Conference, 19 June 2017, London).

<sup>103</sup> *ibid.*

under the UK law.<sup>104</sup> Furthermore, in the Privy Council case *Singularis*,<sup>105</sup> Lord Sumption reaffirmed that ‘the principle of modified universalism is a recognised principle of the common law’, but the courts’ power is limited to its own statutory and common law powers.<sup>106</sup> However, US judges have adopted a flexible approach, inherited from the former law Section 304, and have taken an international-minded approach by showing a willingness to grant relief to foreign representatives based on the foreign law when it is appropriate.<sup>107</sup> The different interpretations of modified universalism are one of the reasons for the inconsistent application of the Model Law in enacting countries, and this point will be discussed in detail in the next chapter.

## 2.5 Conclusion

In this chapter, it has been observed that an enterprise’s financial distress is always caused by multiple pressures, and for international companies, those pressures are more severe because of factors like local competition and regulations. When cross-border insolvency occurs, it leads to complicated legal issues; the fundamental differences among domestic insolvency laws and the preference to protect local interests and creditors are the two main reasons behind the complexity. With the development of modern business, insolvency laws are now paying more attention to corporate rescue in order to improve market stability and sustainability. The trend could be more vital for multinational cases with worldwide influence. For the purpose of maximising creditors’ interests or achieving better restructuring plans, cooperation among creditors and courts in different jurisdictions is needed; furthermore, the most important step for solving international insolvency is how to accomplish a judgement’s extraterritorial effects in other countries. Therefore, an effective system for regulating cross-border insolvency requires being not only

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<sup>104</sup> *Rubin and another v Eurofinance SA* [2012] UKSC 46

<sup>105</sup> *Singularis Holdings Ltd v Price Waterhouse Coopers* [2014] UKPC 36.

<sup>106</sup> *ibid*, para 23.

<sup>107</sup> Adrian Walters (n 81), 54; John J. Chung (n 80), 99.

predictable and accessible, but also recognisable and enforceable in other jurisdictions. Approaches established based on modified universalism seem to be the appropriate solution, providing a comprehensive system to simplify the whole proceedings, and encouraging all the involved courts to work together by allowing the secondary proceedings. More importantly, the concept already has good application at private international law level. However, the different understandings of modified universalism at the national level may have negative effects on the potential consistency encouraged by international insolvency cooperation. Therefore, the next chapter is going to explore whether the UNCITRAL Model Law, which was established based on modified universalism, can achieve international efficiency and consistency.

## **Chapter 3 The UNCITRAL Model Law on Cross-Border Insolvency**

The previous chapter focused on discussions about the nature of cross-border insolvency and basic theories that could be used for solving relevant issues. This chapter will concentrate on the main features of the UNCITRAL Model Law and its enactment in different countries. As the overall purpose of this study is to explore whether the features of the Model Law would be helpful for improving Chinese cross-border insolvency, the function of this chapter is to establish a comprehensive understanding of the operation of the law. Moreover, as a soft law, enacting countries' experiences will be important indicators of the effectiveness of the Model Law, so practical analysis will set out the foundation for the comparative discussion between the Chinese insolvency system and the Model Law.

In this chapter, the application and characteristics of the UNCITRAL Model Law will be examined in detail. After the general introduction of the background of the Model Law in the first part, part two will discuss the basic philosophy and nature of the law. Then, part 3 will focus on the application and the main features of the Model law, including the recognition procedure based on the concept of centre of main interests (COMI), different types of relief, exception articles and the cooperation system under the law. A brief comparative analysis between the European Insolvency Regulation and the Model Law also will be made in this part, with the purpose of further understanding the international origin of the Model Law. The last part looks at the extra protective methods and different interpretations that enacting countries have applied in implementing and enforcing the Model Law; the discussion will focus on the true meaning of the cooperative features of the Model Law and their effectiveness.

### 3.1 International Efforts on Cross-Border Insolvency

The importance of regulating international insolvency is well-recognised by countries, having realised that there should be a system to harmonise those diverse and uncoordinated legal proceedings associated with multinational companies' insolvency.<sup>1</sup> The efforts trying to develop an ideal international insolvency system have a quite long and complicated history. During the early 20<sup>th</sup> century, bilateral or multilateral agreements were developed by some countries to regulate multinational insolvency issues. The experience of the European Union provides a good example of those regional regimes. The adoption of the Council Regulation on Insolvency Proceedings 1346/2000 of 29 May 2000 illustrates it is possible to have a unified insolvency solution among states with multiple political, commercial and legal systems.<sup>2</sup> However, the application of those agreements is usually limited to a regional group of participating countries that are geographical neighbours or trading partners, and it requires a certain degree of similarity in those counties' commercial law systems.

In response to the expansion of international trade and the growth of multinational enterprises, countries that are neither neighbours nor trading partners also face international insolvency issues.<sup>3</sup> Especially with the rapid development of emerging markets in the global economy, the international market requires a global solution that can solve cross-border insolvency problems beyond territorial boundaries.<sup>4</sup> As a result, more efforts at both

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<sup>1</sup> Jenny Clift, 'The UNCITRAL Model Law on Cross-Border Insolvency-A Legislative Framework to Facilitate Coordination and Cooperation in Cross-Border Insolvency' (2004) 12 *Tulane Journal of International and Comparative Law* 307.

<sup>2</sup> Council Regulation (EC) 1346/2000 on Insolvency Proceedings (It has been amended by Regulation (EU) 2015/848 of the European Parliament and of the Council on Insolvency Proceedings (Recast), which came in to effect in 2017) (hereinafter EIR).

<sup>3</sup> Ian F. Fletcher (ed), *Cross-Border Insolvency: Comparative Dimensions: The Aberystwyth Insolvency Papers* (London: The United Kingdom National Committee of Comparative Law, 1990).

<sup>4</sup> Steven T Kargman, 'Emerging Economics and Cross-Border Insolvency Regimes: Missing BIRCs in the International Insolvency Architecture (Part 1)' (2012) *Insolvency and Restructuring International* 8.

national and international have been made for finding a better framework for multinational insolvencies. For example, the Business Law section of the International Bar Association developed the Model International Insolvency Cooperation Act (MIICA).<sup>5</sup> Although the regime has not been widely recognised, it still indicates the importance of government cooperation for solving international insolvency, and that the concept of model law could be a possible solution. In addition, it provided some valuable experience in developing the UNCITRAL regime.<sup>6</sup> Furthermore, both the World Bank and the International Monetary Fund have emphasised the importance of the convergence of national insolvency laws in a time of globalisation, and the necessity of a cross-border insolvency system.<sup>7</sup>

Having realised the importance of cross-border insolvency, and that it would not be possible in the foreseeable future to have a unified substantive law for different legal systems, UNCITRAL formed a Working Group of delegates from various countries and international organisations to draft the Model Law, focusing on procedural issues such as cooperation among the courts, foreign representatives' access to local courts and effects of recognition. Developing this law was explained as a realistic approach to find possible solutions for issues in a relatively short time.<sup>8</sup> After three years' negotiations and review, the Model Law was adopted by consensus on May 30, 1997. The introduction of the Model Law was a significant achievement, and countries were recommended to use that as an opportunity to review their legislation on their cross-border insolvency laws and give favourable consideration on the adoption of the Model Law. At the time of writing, there are 45 jurisdictions that

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<sup>5</sup> See generally: Elizabeth K. Somers, 'The Model International Insolvency Cooperation Act: An International Proposal for Domestic Legislation' (2011) 6 (4) *American University International Law Review* 677.

<sup>6</sup> UNCITRAL, UNCITRAL Practice Guide on Cross-Border Insolvency Cooperation (2009). 11 < [http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/2009PracticeGuide.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/2009PracticeGuide.html) > accessed 10 June 2015.

<sup>7</sup> The World Bank, *Principles for Effective Insolvency and Creditor/Debtor Regimes* (2015); IMF, *Orderly & Effective Insolvency Procedures* (1999).

<sup>8</sup> Felicity Deane and Rosalind Mason, 'The UNCITRAL Model Law on Cross-Border Insolvency and the Rule of Law' (2016) 25 (2) *International Insolvency Review* 139, 150.

have enacted the Model Law as part of their domestic law, including some of the world's most economically powerful countries, such as the US and the UK.

### 3.2 The Nature of the UNCITRAL Model Law

The Model Law was designed to 'assist States in equipping their insolvency laws with a modern, harmonised and fair framework to address more effectively instances of cross-border insolvency'.<sup>9</sup> In order to achieve this goal, the Working Group drafted this law as a model law rather than a convention, which means that it is a list of legislative recommendations for countries to adopt as part of national law.<sup>10</sup> The main reason for having a model law was that national insolvency laws usually have a close relationship with national judicial and civil laws; the Model Law would respect the differences in domestic insolvency regimes.<sup>11</sup> The Working Group believed that, with proper guidance, the Model Law would be more effective in solving cross-border issues.<sup>12</sup> As a result, the Model Law was accompanied by a Guide to Enactment, which provides detailed background and explanatory information for each article.<sup>13</sup>

The nature of the Model Law gives countries the freedom and flexibility to modify, or even leave out, certain provisions if it is necessary. Such flexibility is important for greater acceptance of the law around the world, rather than a treaty.<sup>14</sup> The aim of the drafters was that a majority of countries would adopt

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<sup>9</sup> UNCITRAL, *UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation* (1999) (revised 2013) 19 (The Model Law Guide). <<https://www.uncitral.org/pdf/english/texts/insolven/1997-Model-Law-Insol-2013-Guide-Enactment-e.pdf>> accessed 20 May 2017.

<sup>10</sup> UNCITRAL, *The UNCITRAL Guide: Basic Facts about the United Nations Commission on International Trade Law* (2007), 14-16.

<sup>11</sup> The Model Law Guide, 19-23; Bob Wessels (ed.), *Cross-Border Insolvency: International Instruments and Commentary* (Kluwer Law International 2007), 4-5.

<sup>12</sup> The Model Law Guide, 24.

<sup>13</sup> The Model Law Guide (n 9).

<sup>14</sup> Paul Omar, 'Communication and co-operation between insolvency courts and personnel' (2006) *International Company and Commercial Law Review* 120.

the law and a certain degree of uniformity could be achieved in this legal area.<sup>15</sup> The Guide to Enactment also specifically recommended countries to make as few modifications as possible in order to maintain a satisfactory degree of unification and certainty.<sup>16</sup> There are five objectives set out in the preamble of the Model Law, including: cooperation between foreign courts and authorities, greater legal certainty, fair and efficient cross-border insolvency, protection of debtor's assets, and the desire to encourage the rescue of troubled international businesses. All countries would expect to achieve those five goals if they had a cross-border insolvency regime; therefore, most jurisdictions are encouraged to choose to adopt it with little or no modification.<sup>17</sup> Furthermore, the Model Law was designed with the purposes of effectively solving multinational insolvency and promoting an international market environment, so in order to act in the common interest, individual countries are encouraged to retain uniformity as much as possible.<sup>18</sup>

The "soft" law nature is the main difference between the Model Law and the European Regulation. Although both regimes have implemented the philosophy of modified universalism and similar concepts such as COMI and establishment, their implementation is established based on different principles.<sup>19</sup> The primary concern of the Model Law is to facilitate the national law to deal with inbound foreign insolvency proceedings, and to encourage cooperation between proceedings. In contrast, the European system was established based on market integration, so its insolvency regulation is a mandatory rule among all member states, and mutual trust and recognition

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<sup>15</sup> The Model Law Guide, 49.

<sup>16</sup> *ibid*, 25.

<sup>17</sup> M. Cameron Gilreath, 'Overview and Analysis of How the United Nations Model Law on Insolvency Would Affect United States Corporations Doing Business Abroad' (2000) *Emory Bankruptcy Developments Journal* 399.

<sup>18</sup> Law Commission, *Insolvency Law Reform: Promoting trust and Confidence* (Law Commission 2001) < <http://www.nzlii.org/nz/other/nzlc/sp/SP11/SP11.pdf> > accessed 2 August 2013 (NZ).

<sup>19</sup> EIR, Recital 23 of the Preamble; Jay L. Westbrook, 'Chapter 15 at Last' (2005) 79 *Am. Bankr. L.J.* 713, 716 and Edward J. Janger, 'Universal Proceduralism' (2007) 32 *Brooklyn Journal of International Law* 819, 824.

among different judicial systems is the underlying principle.<sup>20</sup>

Some would argue that its flexibility would be a disadvantage for the Model Law. For example, it may lead to conflicts between one state which has decided to adopt a few provisions into domestic law and another country which has enacted a whole part of it. In this case, there would be no guarantee of uniformity in the quantity of adopted provisions among enacting countries, and the quality of the application of the Model Law would suffer. In fact, because of the nature of soft law, the Model Law has been implemented differently in enacting countries,<sup>21</sup> and the freedom to modify and interpret has caused inconsistencies in practice. Hence, in this chapter, those variations at the national level will be used as examples to discuss the true meanings of the Model Law's provisions.

### **3.3 The Operation and Main Features of the Model law**

The scope of the Model Law extends to foreign proceedings relating to insolvency if the proceeding is collective and the assets of the debtor are subject to court control. It means that various proceedings will be entitled to recognition, whether it is compulsory or voluntary, winding-up or reorganisation.<sup>22</sup> However, the insolvency of financial institutions may not be regulated by the Model Law as those entities are usually administered under special regulatory regimes.<sup>23</sup> One of the most important purposes of the Model Law is to provide direct access for foreign representatives to the courts

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<sup>20</sup> Gerard McCormack and Hamish Anderson, 'Brexit and Its Implication for Restructuring and Corporate Insolvency in the UK' (2017) 7 *Journal of Business Law* 533.

<sup>21</sup> Gerard McCormack, 'US Exceptionalism and UK Localism? Cross-Border Insolvency Law in Comparative Perspective' (2016) 36 *Legal Studies* 136; Look Chan Ho, 'Applying Foreign Law – Realising the Model Law's Potential' (2010) *Journal of International Banking Law and Regulation* 552.

<sup>22</sup> The Model Law Guide, 40.

<sup>23</sup> *ibid.*

of a country which is an enacting country.<sup>24</sup> It proposes a cooperative approach that enables faster action than through diplomatic methods. Other than direct access, foreign representatives also have the right to commence local proceedings in the recognising country based on local laws, or to participate in a local proceeding concerning the same debtor, or to intervene in individual actions in the recognising country affecting the debtor or its assets.<sup>25</sup> Apart from direct access for foreign representatives, protection of foreign creditors is another intention. The Model Law provides that foreign creditors should be treated equally to local creditors for the purpose of starting insolvency proceedings or participating in local proceedings in an enacting country.<sup>26</sup> Although the priority in distribution will be decided by local laws, the Model Law requires that an enacting country should treat foreign creditors at least as well as a local unsecured creditor, provided that the equal local claim would receive at least that treatment.

### **3.3.1 The Jurisdiction and Choice-of-Law**

The Model law adopted a system that has characteristics of modified universalism. There are two types of proceedings under this system, named main proceeding and non-main proceeding. In order to identify these proceedings, the concepts of centre of main interest (COMI) and establishment were applied, which means that if the foreign proceeding was opened in the country where the COMI of the debtor is located, the proceeding should be identified as the main proceeding by the recognising court. The idea of non-main proceeding is identified as “a foreign proceeding, other than a foreign main proceeding, taking place in a State where the debtor has an establishment”; and then, additional proceedings can be opened in those countries other than the state where the COMI is located.<sup>27</sup> Moreover, the power of the non-main proceeding is only limited to the assets within the territory. The term “establishment” means “any place of operations where the

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<sup>24</sup> *ibid*, 27; The UNCITRAL Model Law on Cross-Border Insolvency (The Model Law), Article 9.

<sup>25</sup> *ibid*; The Model Law, Article 11.

<sup>26</sup> *ibid*, 107; the Model Law, Article 32.

<sup>27</sup> The Model Law, Article 2.

debtor undertakes a permanent economic activity.”<sup>28</sup> While Article 2 of the Model Law does not contain a definition of the term “centre of main interests”, Article 16 provides a presumption that, “in the absence of evidence to the contrary, the debtor’s registered office, or habitual residence in the case of an individual, is presumed to be the centre of the debtor’s main interests.” The main difference between being recognised as a main proceeding and a non-main proceeding is in how the foreign proceeding will be treated by the courts applying the model law, and what specific provisions of the domestic insolvency law will be applied to it. For example, certain provisions of the law will automatically apply upon recognition of a foreign main proceeding, but not of a foreign non-main proceeding. For example, primary relief such as a stay of individual enforcement action against the foreign debtor or his assets, or a suspension of the debtor’s right to transfer assets, would be triggered upon recognition of a main proceeding.<sup>29</sup>

The interpretation of the concept of centre of main interests (COMI) is the central factor that effectively operates the Model Law. Apparently, a debtor could have its headquarters and principal operating facilities in a different country than where its registered office is located, and evidence of such a situation might be used to rebut the presumption provided by Article 16. This could potentially lead to a conflict if two jurisdictions have different definitions of the meaning of the centre of main interests. This issue has begun to influence the use of international regimes, both the Model Law and the EU regulation. The more detailed explanation of the concept was given in the judgment of the *Eurofood* case,<sup>30</sup> which was a long-awaited judgment for applying COMI in practice. It stated that COMI must be the place of the company’s central administration, which is responsible for the management and supervision of the company. While the European court provided some guidance for deciding COMI, the US judges tried to make a clearer standard for this issue. Still, the application of the concept varied under different legal systems, and the detailed discussion on this issue will be conducted in the

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<sup>28</sup> The Model Law, Article 2 (f).

<sup>29</sup> The Model Law, Article 20.

<sup>30</sup> *Eurofood IFSC Ltd* (Case C-341/04) [2006] B.C.C 397.

next section.

The Model Law did not provide unified choice-of-law rules and took a neutral position on this matter, so enacting countries needed to apply their private international laws to decide the applicable law. The purpose of the Model Law is to encourage an effective cross-border insolvency solution operating as part of the domestic legal system.<sup>31</sup> So the neutral design would help to reduce the time-consuming procedures and facilitate quick access to foreign proceedings for purposes of asset preservation.<sup>32</sup> More importantly, it reflects the principle of modified universalism and provides flexibility for contestation between divergent legal systems.<sup>33</sup> Therefore, it has been argued that such neutrality is the feature or advantage of the Model Law. Another similar flexibility under the law is that there is no reciprocity requirement, which is making it easier to invoke the law.<sup>34</sup> So a non-enacting country can also invoke the Model Law to seek recognition in an enacting country.<sup>35</sup> For example, if the main proceeding is opened in China, which is not an enacting country, the representative from this proceeding can still seek recognition in the US, based on the Model Law, because the US is an enacting country. Hence, the COMI of cross-border companies can be in any country, and the application of the Model Law will not be limited to those enacting countries.

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<sup>31</sup> Paul J. Omar, 'The UNCITRAL Insolvency Initiative: A Five-year Review' (2002) *Insolvency Lawyer* 228.

<sup>32</sup> Andre J. Berends, 'The UNCITRAL Model Law on Cross Border Insolvency: A Comprehensive Review' (1998) 6 *Tulane Journal of International Comparative Law* 309, 319-321.

<sup>33</sup> Adrian Walters, 'Modified Universalisms & the Role of Local Legal Culture in the Making of Cross-Border Insolvency Law' (2017) *American Bankruptcy Law Journal* [forthcoming], 16 <[https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3084117](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3084117)> accessed 12 March 2018.

<sup>34</sup> Keith D. Yamauchi, 'Should Reciprocity Be a Part of the UNCITRAL Model Cross-Border Insolvency Law' (2007) 16 *International Insolvency Review* 145.

<sup>35</sup> Irit Mevorach, 'On the road to universalism: a comparative and empirical study of the UNCITRAL Model Law on Cross-border Insolvency' (2011) *European Business Organization Law Review* 517.

### 3.3.2 The Concept of Centre of Main Interest (COMI)

COMI plays the essential role in the Model Law since the operation is based on the recognition of main or non-main proceedings. In order to understand the concept and its application, this part discusses the COMI under the Model Law from a practical perspective.

As one of the supporters and enacting members of the Model Law, the US courts have discussed the issue in some influential cases. In *Re Sphinx*,<sup>36</sup> the insolvent debtors were incorporated in the Cayman Islands, and most of their assets were in the United States. Most of their assets were located in the US, and business administration and management were mainly conducted in the US. The debtors did not conduct trading or business in the Cayman Islands, and the only activities they conducted there were limited steps to maintain the debtors in standing as registered Cayman Islands companies. The debtors went into liquidation in the Cayman Islands, and the representatives appointed by this proceeding tried to seek recognition under Chapter 15 of the Bankruptcy Code in the US.

In deciding the COMI of the debtors, although there was evidence showing that COMI was outside of Cayman Islands, the court was inclined to agree that the Cayman Islands were the location of COMI because the proceeding in the Cayman Islands could influence all the investors, and there were no other pending proceedings against the debtors; also, there were no objections submitted against such recognition. The court eventually did not recognise the proceeding as the main proceeding because the investors' tacit consent to the Cayman Islands proceeding was for an improper purpose; it was thus recognised as a non-main proceeding.<sup>37</sup> Although the conclusion was not wrong, the reasoning process received criticisms from commentators. Since the court could have reached the conclusion that the COMI location was the US, the foreign proceeding had already lost the eligibility to be recognised as

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<sup>36</sup> *In Re SPhinX, Ltd*, 351 B.R. 103 (Bankr, SD N.Y. 2006).

<sup>37</sup> *ibid*, para 122.

the main proceeding.<sup>38</sup> Therefore, as an early case concerned with the problem of COMI after the adoption of the Model law, the US court showed some misunderstandings of the Model Law structure. Nevertheless, the court discussed some specific factors to rebut the presumption that the registered location was the COMI, provided “Various factors, singly or combined, could be relevant to such a determination: the location of the debtor’s headquarters; the location of those who actually manage the debtor; the location of the debtor’s primary assets; the location of the majority of the debtor’s creditors or of a majority of the creditors who would be affected by the case; and/or the jurisdiction whose law would apply to most disputes...”<sup>39</sup>

Another noticeable case related to the definition of COMI was *Bear Stearns*.<sup>40</sup> The debtors in question had a similar situation as the debtor in the previous case. Their registered offices were in the Cayman Islands, which was the only connection that the debtors had in that place. The court found that the only business done in the Cayman Islands was limited to keep those companies as registered companies there; moreover, there were no employees and managers in the registered place, and all the assets and business activities were conducted in the United States. Based on those facts, the presumption, which is debtors’ COMI should be the place of the debtor’s registered office, could be rebutted. The court held that the proceedings in the Cayman Islands could not be recognised as foreign main proceeding, and as there were no commercial activities conducted in the registered place, so the proceedings also could be recognised as non-main proceeding.

In the decision, the judgment made it clear that the reasoning in *SPhinX* was incorrect. It stated that courts must make an independent decision as to whether the foreign proceeding meets the definitions under Chapter 15, and the reasoning that the court gave in the first case was not made based on the

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<sup>38</sup> Daniel M. Glosband, ‘*SPhinX* Chapter 15 Opinion Misses the Mark’ (2007) 25 *American Bankruptcy Institute Journal* 83.

<sup>39</sup> *In Re SPhinX, Ltd* 351 B.R. 103 (Bankr, SD N.Y. 2006), para 112.

<sup>40</sup> *In Re Bear Stearns High-Grade Structured Credit Strategies Master Fund Ltd* (2007) 374 BR 122 and affirmed (2008) 389 BR 325.

specific articles of the law.<sup>41</sup> However, the judge agreed and cited the same factors that should be considered for deciding COMI for *SPhinX*.<sup>42</sup>

Another important point is that the US court considered the decision of *Eurofoods* case under the European Regulation. The US judges agreed with the European approach that the presumption is rebuttable when the debtor's registered place is offshore islands, and no material business activities were conducted in such a location.<sup>43</sup>

Although the US courts considered the reasoning of the European case, it does not mean the function of COMI is the same under the two regimes. Look Chan Ho stated in his article: "especially given that COMI is not a defined term and is thus capable of a spectrum of interpretations, its true meaning is to be determined by reference to the purpose and context of the legislation in question".<sup>44</sup> Under the European regulation, identifying the location of COMI seems more important. The Regulation states the COMI had to be identified by reference to criteria that were objective and ascertainable by third parties, and the objective of it is to provide certainty and foreseeability for company creditors.<sup>45</sup> Moreover, the certainty and foreseeability of the COMI could be essential for the application EC regulation, because the member state where the COMI is located has the jurisdiction to open the insolvency proceedings, and the law of that member state will be applied.<sup>46</sup> The judgment of such proceedings will be automatically recognised in all member states.<sup>47</sup> Hence, with all of these following effects tied up with the location of the COMI, it is necessary to ensure the certainty. From the point of view of creditor protection,

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<sup>41</sup> *ibid*, para 131-133.

<sup>42</sup> *ibid*, para 128.

<sup>43</sup> *ibid*, para 129-130; see also Look Chan Ho, 'Proving COMI: Seeking Recognition under Chapter 15 of the US Bankruptcy Code' (2007) 49 *J. Int'l Banking L. & Reg.* 636.

<sup>44</sup> Look Chan Ho, 'Cross-Border Fraud and Cross-Border Insolvency: Proving COMI and Seeking Recognition under the UK Model Law' (2009) *Butterworths Journal of International Banking and Financial Law* 537, 538.

<sup>45</sup> EIR, Recital 30 of the Preamble.

<sup>46</sup> *ibid*, Article 3 (1); Article 4 (1).

<sup>47</sup> *ibid*, Article 19.

creditors need to be able to foresee the insolvency risks associated with a debtor, and the possible jurisdictions that may govern the insolvency risks. Hence, because of the important function of the COMI, it is reasonable that the European courts gave the presumption significant weight. It also should be noted that the EC regulation was designed to work within the European Union, which is a closely united political and economic community, so it has conditions and a legal environment to ensure its application.

Under the Model Law, the role of the COMI is to determine the nature of the foreign insolvency proceedings when seeking recognition, and the concept has no effects on deciding which jurisdiction to open insolvency proceedings or choice-of-law rules. The rationale behind the law is to focus on the recognition and assistance for foreign insolvency proceedings, not to decide the appropriate jurisdiction to open insolvency proceeding. For creditors, no matter where the COMI is located, the foreign main proceedings will be entitled to the same recognition and assistance under the Model Law; therefore, the COMI is less significant than in the European Regulation. Furthermore, it is clear that the Model Law has provided a modest way to solve international insolvency, so no matter if a foreign proceeding is recognised as the foreign main proceeding or non-main proceeding, the law allows the recognising court to make relief in discretion. Therefore, it seems that the law allows for flexibility in deciding the COMI. In the Guide to Enactment, it gave a clear rationale for the presumption:

“Article 16 established presumptions that allow the court to expedite the evidentiary process; at the same time they do not prevent, in accordance with the applicable procedural law, calling for or assessing other evidence if the conclusion suggested by the presumption is called into question by the court or an interested party.”<sup>48</sup>

The method which the US court applied reflects the rationale of the Model Law. The registered office does not have special evidentiary value and does not

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<sup>48</sup> The UNCITRAL Model Law on Cross-Border Insolvency Law with Guide to Enactment and Interpretation (the UNCITRAL Guide), at para 137.

shift the burden of proof;<sup>49</sup> thus, if the foreign proceeding is not in the country of the registered office, then the foreign representative bears the burden of proof on the question of the COMI. If the foreign proceeding is in the country of the registered office, and if there is evidence that the COMI might be elsewhere, then the foreign representative must prove that the COMI is in the same country as the registered office.<sup>50</sup> Following this logic, US judges used the concept of “the principal place of business” to determine the COMI. The notion, which means the place where the central management directs, manages and coordinates the company’s commercial activities,<sup>51</sup> is consistent with the factors listed in the *Bear Stearns* case. Therefore, the judges should make a comprehensive decision based on all the relevant evidence.

In conclusion, the development of the US approach in deciding the COMI location seems an appropriate interpretation of COMI under the Model Law. One piece of evidence is that such an approach has also been recognised by the European system. The new recast provides a comprehensive assessment of all relevant factors which should be made to rebut the COMI presumption.<sup>52</sup> The flexible and comprehensive test is more applicable for jurisdictions with different legal systems. Therefore, the US approach may be a good reference for other countries that have adopted or are preparing to adopt the Model Law.

### **3.3.3 The Recognition and Relief**

After the submission of a petition and the information required to seek recognition, the recognising court can grant provisional interim relief based on Article 17 of the Model Law, if foreign debtors can show that such “relief is urgently needed to protect the assets of the debtor or the interests of the

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<sup>49</sup> *Re Tri-Continental Exchange Ltd* (2006) 349 BR 629 at 635; see also Gerard McCormack, ‘US exceptionalism and UK localism? Cross-Border Insolvency Law in Comparative Perspective’ (2016) 36(1) *Legal Studies* 136.

<sup>50</sup> *ibid.*

<sup>51</sup> *Hertz Corp v Friend* (2010) 559 US 1, para 14-15.

<sup>52</sup> EIR, Preamble (30).

creditors”.<sup>53</sup> Then, the court should take sufficient time to decide whether the application qualifies for recognition as a main or non-main proceeding at the earliest possible time.<sup>54</sup> However, under the Model Law, it is important to notice that there are no automatic effects until the recognition has been granted. Certain automatic reliefs for main proceedings are followed by recognition under article 20, which includes the rule that no proceedings to execute upon the assets of the debtor may be brought, and any proceedings underway will be suspended, and the right to transfer or to encumber any assets of the debtor will be suspended, unless such action actually corresponds to the normal business operation of the company. Furthermore, the decisions of granting reliefs for non-main proceedings are entirely discretionary. Additionally, for both main and non-main proceedings, the recognising court can also grant additional relief at their discretion, such as extending the stay of proceedings or appointing the foreign representative to administer the local assets.<sup>55</sup>

Therefore, regarding available relief, the Model Law gives recognising countries more space to consider the real circumstances of the individual case, then reach appropriate decisions.<sup>56</sup> More importantly, the flexibility also provides a condition that foreign representative and the local court can conduct cooperative methods wherever possible.<sup>57</sup> For instance, if the local court entrusts the representative for the local assets, there is more possibility of conducting an international reorganization or deal with the debtor’s assets as an entirety, and the solution will be better for both debtor and creditors. Those articles of granting relief give courts a great level of freedom to tailor appropriate relief to ensure the interests of both creditors and debtors are best met.

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<sup>53</sup> The Model Law, Article 19.

<sup>54</sup> *ibid*, Article 17 (3).

<sup>55</sup> *ibid*, Article 21 (1) (g).

<sup>56</sup> Irit Mevorach (n 35), 543.

<sup>57</sup> Paul J. Omar, ‘The UNCITRAL Model Law on Cross-Border Insolvency’ (1999) *International Company and Commercial Law Review* 242.

### 3.3.4 Safeguards under the Model Law

In order to protect national sovereignty, the Model Law contains some provisions which can be treated as safety exceptions, or ‘concessions’, as described by Mohan.<sup>58</sup> Some of those articles can be a double-edged sword; they can promote the adoption of the Model Law globally, but also may undermine the intended objectives of the law if countries overuse them.<sup>59</sup>

Article 1(2) of the Model Law permits a State to exclude certain entities from the operation of the Model Law, such as a bank or insurance company that may be subject to a “special insolvency regime”. The reasons for the exclusion of such entities is that their insolvency may require protection of interests of a large number of individuals, and insolvency of financial institutions requires particularly prompt and circumspect actions.<sup>60</sup> However, it is advisable to adopt some features of the Model Law to be applicable to specially regulated insolvency proceedings, such as the cooperation and discretionary relief sections.<sup>61</sup> It has been pointed out that since the objective of the Model Law is to facilitate cross-border insolvency problems that may relate to assets in various jurisdictions, such exclusions should be limited.<sup>62</sup> The divergence in adopting this article may cause confusion in practice. For example, a financial institution’s insolvency proceedings could be recognised under the Model Law system in some jurisdictions, but not in other jurisdictions which choose to exclude all financial institutions from the operation of the Model Law. Such a situation is in conflict with the efficiency objective of the system.

Article 3 is about the preservation of the right of a State to honour its treaty or other agreement obligations should there be a conflict between the treaty and the Model Law. It expresses the principle of the supremacy of international treaty obligations of a state. For instance, under the British Model Law, the

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<sup>58</sup> S. Chandra MOHAN, ‘Cross-border Insolvency Problems: Is the UNCITRAL Model Law the Answer?’ (2012) *International Insolvency Review* 199, 203.

<sup>59</sup> *ibid.*

<sup>60</sup> The Model Law Guide, 35-36.

<sup>61</sup> *ibid.*

<sup>62</sup> *ibid.*

Cross-Border Insolvency Regulations 2006, it states that when the application of the Model Law is in conflict with the UK's obligations under the European Insolvency Regulation, the EU law will prevail.<sup>63</sup>

Article 6 emphasises the public policy exception, which provides a state's courts may refuse to "take action governed by this Law if the action would be manifestly contrary to the public policy" of the State.<sup>64</sup> The article is necessary for enacting countries even if they have their own exceptional provisions in their private international laws because the international public policy provision is usually wider than domestic ones, and mostly focuses on issues regarding cross-border cooperation.<sup>65</sup> Thus, when enacting countries adopt the international articles, it could provide a better environment for cooperation for international issues. The Model Law does not define "public policy" as "the notion of public policy is grounded in national law and may differ from State to State".<sup>66</sup>

### 3.3.5 Cooperation

Another feature that should be noticed is the provisions about cooperation among recognising courts, foreign courts and representatives. The cooperation and coordination principle is reflected primarily in articles 25-27. Article 25 clearly states that the courts should cooperate to the maximum extent possible with foreign courts or their representatives. Cooperation among involved parties to a cross-border insolvency proceeding is indispensable to the law's effectiveness; therefore, the Model Law applies strict and non-precatory language, which imposes mandated duty to the courts.

<sup>67</sup> It further provides that the court is entitled to communicate directly with or

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<sup>63</sup> CBIR 2006, Article 3.

<sup>64</sup> The Model Law, Article 6.

<sup>65</sup> The Model Law Guide, 52; see also Michael A. Garza, 'When is Cross-Border Insolvency Recognition Manifestly Contrary to Public Policy' (2015) 38 (5) *Fordham International Law Journal* 1588.

<sup>66</sup> The Model Law Guide, 52.

<sup>67</sup> Ronald J. Silverman, 'Advances in Cross-Border Insolvency Cooperation: the UNICTRAL Model Law on Cross-Border Insolvency' (2000) *ILSA J. Int'l & Comp. L* 265.

to request information or assistance directly from, a foreign court or foreign representatives. Such entitlement avoids traditionally time-consuming procedures when gaining information from foreign courts, such as through higher courts or diplomatic channels. Nevertheless, the law gives discretion to local courts to interpret “the maximum extent”. Allowing domestic courts to determine the degree of cooperation can be seen as another flexibility of the Model Law. The advantage can be shown in a case which may involve two countries respectively adopting a common law system and a civil law system. For the common law country, the actions of cooperation may include communication with the foreign courts directly; in contrast, the actions of the court in the civil law country will be limited to the local law. Therefore, no uniform requirement on the ways of cooperation may be effective; so the freedom can give recognising courts more space to decide their methods of cooperation based on domestic regulation, and achieve real maximisation of efficiency.

The UNCITRAL Guide suggests that authorisation of direct communication is necessary to avoid the need for procedural formalities that might otherwise cause delay. Such a development might be difficult to be accommodated by some legal systems because of the ingrained opinion that direct communication might undermine the principle that courts in one jurisdiction should not interfere in, or seek to influence, decision-making which properly belongs to the courts of another.<sup>68</sup> For this matter, the courts should always have a clear awareness of the judicial functions they need to fulfil; so, as long as the communication is conducted applying certain safeguards, there is no reason to refuse such direct communication. As a matter of fact, the principle of direct communication has been well-established and recognised in legal circles, and the *Guidelines Applicable to Court-to-Court Communication in Cross-border Cases*, published by the American Law Institute, is a good example.<sup>69</sup> The guidelines have been discussed and debated widely on

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<sup>68</sup> William Trower QC, ‘Court-to-Court Communication-The Benefits and the Dangers’ (2007) 4 (3) *International Corporate Rescue* 111.

<sup>69</sup> *ibid*; the guidelines were developed by lawyers and academics from three NAFTA countries, The US, Canada and Mexico.

different occasions, and some scholars think they should be applied worldwide for cross-border cases.<sup>70</sup>

Under the interpretation of the law, UNCITRAL has also provided some guidelines on this matter. Firstly, the communication should be conducted carefully in order to protect the substantive and procedural rights of the parties, and advanced notices should be given to involved parties. Then, there are various forms of information which could be communicated using various means of communication.<sup>71</sup> Additionally, there could be considerable benefits for persons involved, if necessary. According to UNCITRAL's note, a common limitation on cooperation between judges from different courts in international insolvency cases derives from the lack of a legislative framework, or uncertainty, regarding the scope of the existing legislative authority for the pursuit of cooperation with foreign courts. The Model law, to some degree, could fill the gap found in many domestic laws by clearly giving the court the power to extend the cooperation within the areas governed by the Model Law, and to communicate directly with foreign parties.<sup>72</sup>

### **3.3.6 Comparison with the European Insolvency Regulation**

The EU Regulation on Insolvency Proceedings, which was entered into force on 31 May 2002, is a comprehensive instrument for solving cross-border insolvency problems among the member states of the European Union. The historical reason to draft the regulation was that there was no complete and ideal treaty on insolvency proceedings to provide enough legal protection for insolvent persons and businesses within the internal European market. With the rapid development of the European Community, more and more business activities have cross-border effects, and it needs a community-level law to govern the insolvency proceedings of such business activities.<sup>73</sup> In order to

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<sup>70</sup> Ian F Fletcher and Bob Wessels, 'Transnational Insolvency: Global Principles for Cooperation in International Insolvency Cases' (Report, The American Law Institute and the International Insolvency Institute, 30 March 2012).

<sup>71</sup> The Model Law Guide, 50.

<sup>72</sup> *ibid*, 94-95; see also Jenny Clift (n 1), 327.

<sup>73</sup> Paolo Manganelli, 'The Modernization of European Insolvency Law: An Ongoing Process' (2016) 11 (2) *Journal of Business and Technology Law* 153; see also: Bob

achieve the aim of establishing an area of freedom, security and justice, the European Union needs a unified insolvency regulation to promote an efficient and effective system concerning the mutual recognition of insolvency proceedings opened in individual member states.<sup>74</sup> As the two most important international regimes regulating international insolvency, there is some common ground between the Model Law and European regulations. Although the interpretation and application of those ideas could be different under the two systems, the aims are the same.

Both seem to embrace the concept that a fair and effective cross-border insolvency regime requires a certain degree of unified procedural rules and maximum cooperation, and the idea that one main insolvency proceeding plays the main role, with restricted territorial proceedings, has been accepted by both systems. Thus, they have both adopted an approach of “modified universalism”.<sup>75</sup> However, not surprisingly, since the EC regulation is for regional use, the law directly has been adopted by all the Member States without any differences in its enactment, while the Model law had to incorporate a more flexible regime for a wider circle of countries. It has been said that the Model law is less ambitious and more modest than the EC Regulation since it leaves more room for the individual states to change the original law based on domestic situations,<sup>76</sup> and this may compromise the intended objectives of the law. Specifically, one of the main differences is that the Model law does not provide clear choice-of-law rules, and the individual nation needs to apply its own private international law, whereas under the EC regulation, the law of the Member State opening the main proceeding will be automatically applied. In addition, the decisions of the main proceeding will be effective in all the Member States, recognition is automatic, and the powers of the representative confirmed by the opening

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Wessels, *European Union Regulation on Insolvency Proceedings: An Introductory Analysis* (American Bankruptcy Institute, 2007), 4-7.

<sup>74</sup> Opinion of A.G. Bobek in *ENEFI v DGRFP (C-212/15)* EU:C:2016:841: [2017] I.L.Pr. 10; see Gerard McCormack and Hamish Anderson (n 20), 535.

<sup>75</sup> See note 19.

<sup>76</sup> Gerard McCormack (n 21), 140; Irit Mevorach (n 35), 523

court will be recognised by all other Member States.<sup>77</sup> Therefore, the system, which includes one main proceeding, one law and automatic recognition, seems more comprehensive for accomplishing the unitary goal of insolvency.

One main reason for the significant differences between the two systems is the different performance stages. The Member States of the European Union have the agreement and intention to build a unified area, which means that the political integration of Europe makes the application of uniform rules possible. For the Model law, the enacting jurisdiction could be all the member of the United Nations, which with various legal systems and national ideology; thus, flexibility could be the only way to make the law acceptable by them. On the other hand, although the rationales of the two regimes could be the same, the focuses are different. The EIR proposes a regime which concentrates on the ascertainment of jurisdiction by the court opening insolvency proceedings, which is achieved through unified rules.<sup>78</sup> The Model law's framework pays more attention to improving the efficiency of the recognition in other jurisdictions of insolvency proceedings by regulating the recognition procedures, and assistance from foreign courts.<sup>79</sup>

Nevertheless, there are more similarities in the details of the two regimes. Both the regimes have applied the concepts of "centre of main interests" and "establishment". As a matter of fact, the Model Law borrowed these concepts from the EC Regulation.<sup>80</sup> The EC Regulation states that the opening court should open main proceedings only if the company's COMI is located in that Member State.<sup>81</sup> Otherwise, if the company only has an establishment in that jurisdiction which can be defined as a physical place of business, the court can only open secondary proceeding, which will be limited to the assets

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<sup>77</sup> EIR, Article 19-21.

<sup>78</sup> Gerard McCormack, 'Reconciling European Conflicts and Insolvency Law' (2014) 15 *European Business Organisation Law Review* 309.

<sup>79</sup> Gerard McCormack and Hamish Anderson (n 20), 537-538; Adrian Walters (n 33), 13.

<sup>80</sup> The Model Law Guide, 22.

<sup>81</sup> EIR, Article 3 (1).

located in that state, and may only be liquidation proceedings.<sup>82</sup> Under the Model law, as aforementioned, the recognition of main and non-main proceedings also builds on the same notions.<sup>83</sup> Therefore, the application of those ideas under both laws follows the model of modified universalism.

Furthermore, both systems include an exception article which allows countries to deny recognition or relief if granting it will be contrary to their public policy. As international regimes, this could be a further “safety valve” when determining whether or not to grant recognition or assistance.<sup>84</sup> According to the EC Regulation, the recognition of insolvency proceedings from another member state can be refused if “such recognition or enforcement would be manifestly contrary to that State’s public policy, in particular, its fundamental principles or the constitutional rights and liberties of the individual.”<sup>85</sup> The Model Law had a similar article and pointed out the interpretation should consider the international perspective of the law.<sup>86</sup> The situation could be more complicated under the Model Law since the definitions of “public policy” in enacting states could be different due to their legal and political backgrounds. It is not possible to standardise the public policy rules and most nations are unwilling to give up such a “safety device”.<sup>87</sup> Yet, the UNCITRAL encourages the policy to be used narrowly.

Importantly, it seems that the application of the exceptional article should be extra narrow under the European regime since the intention is to achieve a unified result in all Member States. The European Court of Justice explained that the public policy exception was reserved for only exceptional cases, and the recognition or enforcement “would be at variance to an unacceptable degree with the legal order of the State in which enforcement is sought since

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<sup>82</sup> EIR, Article 3 (2).

<sup>83</sup> The Model Law, Article 2 (b) (c).

<sup>84</sup> Felix D. Strebler, ‘The Enforcement of Foreign Judgments and Foreign Public Law’ (1999) 21 *Loyola of Los Angeles International and Comparative Law Review* 55, 66.

<sup>85</sup> EIR, Article 33.

<sup>86</sup> The Model Law, Article 6; The Model Law Guide, 52.

<sup>87</sup> The Model Law Guide, 28; Michael A. Garza, ‘When is Cross-Border Insolvency Recognition Manifestly Contrary to Public Policy’ (2015) 38 (5) *Fordham International Law Journal* 1587.

it infringes a fundamental principle”.<sup>88</sup> Additionally, from the macro environment, the European Union is a highly integrated politico-economic union, and its single market policy and comprehensive European Union law system at certain levels provides stable economic and legal conditions for applying a unified insolvency proceeding. No other regional organisations or international treaties could provide such a uniform environment. Hence, a broad interpretation of the exception article would create a conflict with both the objective of the EIR and the development of the European Union itself.

### **3.4 The Implementation at National Level**

As the Model Law is not a mandatory law, the UNCITRAL had suggested that enacting countries should make as few modifications as possible in order to achieve harmonisation and certainty. Professor Wessels said the effective operation of the Model Law “is heavily dependent upon whether, and in what manner, countries choose to enact it”.<sup>89</sup> However, some states did not take the advice and made significant changes to the original articles of the law, and some of the changes could be considered inconsistent with the intended objectives of the law. In this part, the analysis will focus on some examples of those deviations from the Model Law.

#### **3.4.1 The Understanding of Relief**

There is no exact definition of “any appropriate relief” in the Model Law or other official documents from the Working Group, the application of Article 21 has caused some debate in practice, which mainly focuses on the scope and power of this article. Specifically, one main issue is whether “any appropriate relief’ allows the recognising court to grant relief based on the law of the state in which the foreign proceeding was opened. On this matter, the courts in the

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<sup>88</sup> *Dieter Krombach v André Bamberski* (Case C-7/98), [2000], ECR I-1035, para 37.

<sup>89</sup> Bob Wessels, ‘Will UNCITRAL Bring Changes to Insolvency Proceedings Outside the USA and Great Britain? It Certain Will’ (2006) 3 *International Corporate Rescue* 200.

US and the UK have taken different interpretations.

In *Fibria Celulose S/A v Pan Ocean, Co Ltd*,<sup>90</sup> the UK judges held that although the meaning of the article 21(1) is wide, it would not be appropriate to allow the recognising court to grant relief based on the law of the state in which the foreign proceeding was opened. Pan Ocean was a shipping company incorporated under South Korea Law which was in an insolvency proceeding opened in South Korea (an enacting state of the Model Law). The proceeding was recognised as a foreign main proceeding under CBIR 2006. The company had a long-term contract with a Brazilian exporter, Fibria Celulose SA, and their contract was governed by English law. The Brazilian party sought to terminate the contract based on clause 28, which provided the right of termination with immediate effect, with notice in writing for default, including insolvency. The administrator of the Korea Company tried to keep the contract alive since it was still profitable, and such termination provisions could be overridden under the Korean insolvency system. Fibria contended that the Korean law was irrelevant here. Therefore, the Korean administrator made application to the English court and asked the court to issue an order restraining Fibria from relying on clause 28 to terminate the contract, under article 21(1) of CBIR to grant ‘any appropriate relief’.

The problem here was whether the term “any appropriate relief” allows the recognising court to grant relief based on the laws of the state which the foreign proceeding was opened. The court agreed that the meaning of “any appropriate relief” is wide; however, the wide literal meaning does not mean that the court should give it a broad interpretation. Morgan J explained that it would be odd to think that there existed power for a recognising court to grant relief which it would not be able to grant under the laws of the recognising court.<sup>91</sup> He also pointed out that even if he had such a right, it would not be appropriate in this case to apply it since the parties specifically agreed their contract should be governed by English law.<sup>92</sup> By reviewing relevant reports

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<sup>90</sup> *Fibria Celulose S/A v Pan Ocean Co. Ltd* [2014] EWHC 2124 (Ch).

<sup>91</sup> *ibid*, para 112.

<sup>92</sup> *ibid*.

from the Working Group, judges could not find any exhaustive choice-of-law rule under the Model Law. Therefore, the court focused on the wording of Article 21 and stated that sub-paragraph (g) restricted the power of recognising courts within the laws of its state.

‘(g) Granting any additional relief that may be available to a British insolvency officeholder under the law of Great Britain’<sup>93</sup>

The court also referred to US case laws, including cases that were decided based on foreign laws, but the judge did not follow the US approach because there was no legislative history in the UK, and the Model Law had not been implemented identically in those two jurisdictions.<sup>94</sup> Thus, the decision was reached that “any appropriate relief” would not allow the recognising court to go beyond the relief it would grant in relation to domestic insolvency law.

The judgment of the UK case claimed that the wording of Article 21(1) (g) provides clear limitations regarding “any appropriate relief”. However, it is necessary to note the explanation in the Guide to Enactment of the Model law:

“The court is not restricted unnecessarily in its ability to grant any type of relief that is available under the law of the enacting state...The “Under the law of the enacting state” reflects the principle underlying the Model Law that recognition of a foreign proceeding does not mean extending the effects of the foreign proceeding as they may be prescribed by the law of the foreign state. Instead, recognition of a foreign proceeding entails attaching consequences envisaged by the law of the enacting state.”<sup>95</sup>

This explanation makes it clear that recognition of foreign proceeding does not mean the foreign laws have extraterritorial effect in the enacting country, and it also does not restrict the court to applying their own private international law to give effect to foreign insolvency laws. There is no clear choice-of-law

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<sup>93</sup> The Cross-Border Insolvency Regulations 2006 (CBIR 2006), Article 21, sub-s 1 (g).

<sup>94</sup> *Fibria Celulose S/A v Pan Ocean Co. Ltd* [2014] EWHC 2124 (Ch), para 113-114.

<sup>95</sup> The Model Law Guide, 87-88.

rule under the Model Law system, and the Working Group intentionally adopted a neutral position on choice-of-law matters. Furthermore, Article 2 (1) (q) of CBIR, "reference to the law of Great Britain include a reference to the law of either part of Great Britain including its rules of private international law", gives the courts the power to decide the applicable law, which provides the statutory source for courts to apply foreign law when it is appropriate.<sup>96</sup>

In contrast, the US case, *Re Condor Insurance*,<sup>97</sup> can be a good example to show the different approaches applied by the UK and the US courts mentioned by Morgen J in the English case. In this case, the debtor was an insurance company incorporated under the law of Nevis and was the subject of a winding-up order in Nevis in 2007. The United States court recognised the proceeding as foreign main proceedings under Chapter 15. The foreign representative applied to recover a certain amount of assets belonging to the debtor by seeking relief under section 1521 of the bankruptcy code (which is Article 21 of the Model Law) since those US-located assets were fraudulently transferred to the defendants. The causes of action were all governed by Nevis law. The bankruptcy court held that it had no subject-matter jurisdiction over the foreign representatives' action since section 1521 and section 1523 were intended to exclude all the avoidance powers. However, the court of appeal did not agree with the decision and held that although the avoidance powers have been excluded by section 1523, the court had the power to apply Nevis law based on the "appropriate relief" article under section 1521. The court of appeal also made reference to the purpose and structure of the Model Law, and affirmed that Chapter 15 did not intend to prevent US courts from applying the relevant foreign law when it was appropriate.<sup>98</sup>

One of the main reasons for the different interpretations of the Model Law is the influence of national law traditions. The UK judgment regarding Article 21 followed similar opinions of the scope of common law powers under modified

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<sup>96</sup> See discussion: Look Chan Ho, 'Applying Foreign Law – Realising the Model Law's Potential' (2010) *Journal of International Banking Law and Regulation* 552.

<sup>97</sup> *In Re Condor Insurance Limited* (2010) 601 F 3d 319.

<sup>98</sup> *ibid*, para 324-328.

universalism mentioned at the end of chapter 2, which emphasised that the power to cooperate and assist foreign proceedings should be limited within the scope of local laws. The US approach has focused on the international origin of the Model Law; additionally, the prior international insolvency law section 304 also had a good experience when applying foreign law, and the willingness is reflected in the application of chapter 15.<sup>99</sup>

The system of discretionary relief is a good example of the flexibility proposed by the Model Law. This kind of flexibility requires the courts to consider all the circumstances and factors that may influence foreign proceedings in order to make the most suitable decisions which are fair to both the creditors and debtors. The cautious common law opinions from English judges have been treated as a major setback in developing a universalism approach, and apparently, it has also limited the flexibility of the Model Law it intended to achieve.<sup>100</sup>

### **3.4.2 Reciprocity**

Some may argue the flexibility of the Model Law may compromise its intended objectives, and some countries may take the freedom too far and adopt the law with many articles altered in order to be more protective.<sup>101</sup> One reason causing this concern is that several countries have adopted the Model Law with reciprocity requirements, although there is no such requirement in the original law.<sup>102</sup> The intention may be to avoid cooperating with the insolvency proceedings from jurisdictions whose judicial systems might not be reliable and substantively just, or to restrict the use of the Model Law to foreign

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<sup>99</sup> Section 304 cases: *In Re Board of Directors of Multicanal S.A.* 314 B.R. 486 (Bankr. S.D.N.Y. 2004); Chapter 15 case: *In Re Condor Insurance Limited* (2010) 601 F 3d 319.

<sup>100</sup> Gerard McCormack, 'Universalism in Insolvency Proceedings and the Common Law' (2012) 32 (2) *Oxford Journal of Legal Studies* 325; Irit Mevorach, *The Future of Cross-Border Insolvency: Overcoming Bias and Closing Gaps* (Oxford University Press 2018) 43.

<sup>101</sup> S. Chandra Mohan (n 58), 203-204.

<sup>102</sup> Keith D. Yamauchi (n 34).

proceedings from the jurisdictions that have also adopted the law.<sup>103</sup>

The South African approach to reciprocity appears to be the most limited because its Insolvency Act applies only to countries that are designated by the Minister.<sup>104</sup> The condition is that the Minister must be satisfied by the law of the foreign proceeding seeking recognition would offer the same treatment and assistance to South African proceedings. This act was without practical application for a decade, although the country was one of the first few states who chose to adopt the Model Law. In Romania, article 18 of their international insolvency law stated that foreign proceedings would be recognised only if there is a reciprocal arrangement with the foreign country concerned, which rules out most other countries.<sup>105</sup>

Before New Zealand decided to incorporate the Model Law, the law commission suggested that the law should not be applied until its major trading partners, especially Asian countries, had chosen to enact it. So, both developing and developed nations have similar concerns.<sup>106</sup> It is understandable that domestic laws try to protect their own benefits and interests, so finding the balance point between international cooperation and local protection would be crucial in deciding whether an international regime is efficient or not. Adopting reciprocity policy could be the major barrier that limits the development of cross-border cooperation in the future. Countries, including major emerging markets, seem hesitant and apply a wait-and-see attitude towards the Model Law; the trend of the reciprocity requirement may have given them an impression that the application of the law is unreliable, which would discourage the motivation to reform their cross-border insolvency laws.

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<sup>103</sup> Report of the Insolvency Law Review Committee (Singapore), Ch11, para 31-32 <<https://www.mlaw.gov.sg/content/dam/minlaw/corp/News/Revised>> accessed 20 April 2018.

<sup>104</sup> The Cross-Border Insolvency Act 2000, S2, sub-s 2 (b) (South Africa).

<sup>105</sup> The Cross-border Insolvency Law (637/2002), Article 18 (Romania).

<sup>106</sup> Law Commission Report on Cross Insolvency, *Should New Zealand Adopt the UNCITRAL Model Law on Cross-border Insolvency Report 52* <<http://www.nzlii.org/nz/other/nzlc/report/R52/>> accessed 08 August 2017.

In fact, based on the analysis of the main features above, the Model Law is capable of ensuring equality and justice on its own. Article 6 is a good example. Recognition or assistance can be refused based on public policy grounds if the foreign proceeding is a breach of natural justice or fairness. Another example is that the law specifically stated that certain reliefs might only be granted when the local interests are “adequately protected”.<sup>107</sup> The fact is that most major jurisdictions who adopted the law did not include any reciprocity restrictions, which set good examples for other countries, and showed their willingness to build a cooperative framework. The US evidently stated that “the United States was one of the leading countries opposing the inclusion of a reciprocity requirement.” in the Report of the Committee on the Judiciary House of Representatives.<sup>108</sup> Similarly, the UK Parliament shared the same attitude to not imposing any reciprocity requirements in order to send encouraging signals to other countries for adoption.<sup>109</sup> The Singapore Insolvency Law Review Committee pointed out imposing reciprocity rules “would not achieve fully the purpose of having a clear, predictable and comprehensive legal framework for managing all cross-border insolvencies” when it was considering how to incorporate the Model Law.<sup>110</sup>

### 3.4.3 Exclusionary Rules

As mentioned above, the “public policy” article provides the safeguard to refuse foreign proceedings that violate recognising a state’s fundamental interests. Article 6 does not define public policy because the notion could be different in national laws. The national laws’ definitions of public policy can vary in different states. In a broad sense, it can relate to any mandatory rules of domestic laws; in a restricted interpretation, it may be limited to fundamental policies, such as constitutional principles.<sup>111</sup> Some have criticised this,

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<sup>107</sup> The Model Law, Article 21 (2).

<sup>108</sup> Keith D. Yamauchi, ‘Should Reciprocity Be a Part of the UNCITRAL Model Cross-Border Insolvency Law?’ (2007) 16 *International Insolvency Review* 145.

<sup>109</sup> *ibid.*

<sup>110</sup> Report of the Insolvency Law Review Committee (Singapore), Ch 11, para 34.

<sup>111</sup> Elizabeth Buckel, ‘Curbing Comity: The Increasingly Expansive Public Policy Exception of Chapter 15’ (2013) 44 (3) *Georgetown Journal of International Law* 1281.

claiming that such an article potentially gives states more opportunities to avoid recognising foreign proceedings. Furthermore, the Guide to Enactment pointed out that the term “manifestly” is to emphasise public policy exceptions, and it should be narrowly interpreted, and only should be applied under exceptional circumstances.<sup>112</sup>

However, some countries intentionally did not apply the original wording. The Romanian court could refuse the recognition if the foreign proceeding infringes on “Romanian principles of public order”; similarly, violation of the fundamental principles of Mexican law could prohibit the recognition of any foreign proceeding under the Mexican Commercial Insolvency Law of 2000. Article 21(3) of Japanese Law on Recognition and Assistance in Foreign Insolvency Proceeding states “contrary to the public order or good public morals in Japan”.<sup>113</sup> One point is that all those modifications used the term “public order”, which is commonly found in domestic private international laws, especially in civil law countries, and it refers to exceptions that allow a court to refuse to recognise or enforce a foreign judgment on the grounds that such judgment conflicts with fundamental policies.<sup>114</sup> One fact also can be observed: there is no mention of the word “manifestly” in those examples. It would be unfair to say those countries deliberately have the aim of broadening the meaning of public policy exception by ruling out the term; for some countries, such as Canada, Greece, Serbia and South Korea, the omission of the word is just a semantic decision to remove all adjectives and adverbs from legislation.<sup>115</sup> But it cannot be denied that without the word “manifestly”, domestic courts will have more opportunities to manipulate its interpretation. Nevertheless, it should be borne in mind that international public policy should be restrictively interpreted, and broadly applying public policy exceptions

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<sup>112</sup> The Model Law Guide, 52.

<sup>113</sup> Kazuhiko Yamamoto, ‘Japan’ in Look Chan Ho (ed), *A Commentary on the UNCITRAL Model Law* (Global Law and Business, 2006).

<sup>114</sup> Michael A. Garza, ‘When is Cross-Border Insolvency Recognition Manifestly Contrary to Public Policy’ (2015) 38 *Fordham International Law Journal* 1587.

<sup>115</sup> *ibid.*

would hamper international cooperation.<sup>116</sup>

#### **3.4.4 The Rights of Foreign Representatives**

Articles 9 and 11 of the Model Law give foreign representatives direct access to enacting courts and permission to commence proceedings under local insolvency laws. However, a number of enacting states made such rights conditional upon the recognition of the foreign proceeding. South Korea's Rehabilitation and Bankruptcy Act requires that foreign proceedings need to be recognised first for the foreign representative to commence local bankruptcy proceedings, which deviates from the intention of the original Article 11.<sup>117</sup> Under Chapter 15 of the US Bankruptcy Code, a similar condition has been applied. It provides that the rights to commence insolvency proceedings or bring proceedings in other courts in the US will be granted after recognition by US law.<sup>118</sup> Additionally, the US Code adds more restrictions under the direct access section. For instance, section 1509 (d) forbids other courts in the US from providing comity or cooperation to foreign proceedings if the recognition is refused by the bankruptcy court. Such requirements make the bankruptcy courts gatekeepers for foreign representatives seeking assistance from other courts in the US.<sup>119</sup>

The powers of foreign representatives could be more restricted after the recognition. The Working Group considered the concern in respect of the influence of foreign representatives' powers on the protection of local creditors; hence, Article 21 (2) was introduced as another safeguard, which provides that local interests should be "adequately protected" before the courts entrust the foreign representative with the distribution of the local assets. Again, it could be predicted that the safeguard article had a good chance of being manipulated by enacting countries. Japanese law on Recognition of Foreign Proceedings put another level of protection on this section, which requires that,

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<sup>116</sup> Elizabeth Buckel (n 104), 1283.

<sup>117</sup> Rehabilitation and Bankruptcy Act 2005, Article 634 (South Korea).

<sup>118</sup> The US Bankruptcy Code, Ch15, s1509, s1511.

<sup>119</sup> Richard G Mason, 'United States' in Look Chan Ho (ed), *A Commentary on the UNCITRAL Model Law* (Global Law and Business, 2006) para 197.

where the local assets have been entrusted to a foreign representative, he must explicitly ask for approval of the court before turning over the assets to the foreign state. The court needs to ensure the local creditors are not unfairly prejudiced before granting the approval.<sup>120</sup> Such requirement could give the court more opportunities to refuse to submit local assets to a foreign court; besides, such approval process might not meet the efficiency the Model Law required.

US law implemented Article 21 (2) with a slight modification. Subsection (b) of 1521 under the US Bankruptcy Code states that after the court recognises the foreign proceeding as the main or non-main proceeding, the court may turn over the US assets to a foreign representative, “provided that the court is satisfied that the interests of the creditor in the United States are sufficiently protected.”<sup>121</sup> This change has been criticised as a territorialism section which allows the court to provide extra protection to local creditors by adopting the word “sufficient”; it also conflicts with the US claims for encouraging international cooperation and promote the application of the Model Law.

The condition is one of the controversial changes that Chapter 15 drafters added to the original provisions of the Model Law. Jeremy Leong criticised this condition as it jeopardised the universalism essence of the Model Law being a universal system to assist insolvency businesses.<sup>122</sup> Since the decision regarding which forum is allowed to distribute the debtor’s assets affects whether and how many individual creditors will receive compensation in the distribution, and the priorities of creditors for distribution under different national laws could be very different, this provision seems to treat the local creditors over the administration of the foreign proceeding. Professor LoPucki also pointed out in his article that because of the wide differences in insolvency regimes in different jurisdictions, modified universalism may lead to a refusal

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<sup>120</sup> Act on Recognition of and Assistance for Foreign Insolvency Proceedings, Article 35 (Japan).

<sup>121</sup> The US Bankruptcy Code, Ch 15, S 1521 (b).

<sup>122</sup> Jeremy Leong, ‘Is Chapter 15 Universalist or Territorialist? Empirical Evidence from United States Bankruptcy Court Cases’ (2010) *Wisconsin International Law Journal* 110.

to cooperate.<sup>123</sup>

However, the change of wording is not as protective as it seems to be, and it did not change the intention of the original language of the Model Law. According to the explanation regarding the change of wording given by Congress, the term “adequate protection” has conceptual baggage in US legal history; therefore, the change was to avoid confusion with a much specialised legal term in US Bankruptcy history.<sup>124</sup> In *Re Tri-Continental Exchange Ltd*,<sup>125</sup> the court discussed the relationship between “sufficient protection” and the discretionary relief and stated that “the need to tailor relief and conditions so as to balance the relief granted to the foreign representative and the interests of those affected by such relief, without unduly favouring one group of creditors over another”,<sup>126</sup> which followed the Model Law intention, and clarified that the degree of sufficient protection does not mean to overprotect certain groups of local creditors. The aim of this provision was introduced to avoid seriously and unjustifiably injuring US creditors. In addition, the US court applied a cautious attitude when explaining this provision in practice. In *Re Artimm*,<sup>127</sup> the court provided that sufficient protection of US creditors under 1521 (b) involves three factors (connected to the old section 304 (c)):<sup>128</sup>

- (1) The just treatment of all holders of claims against the bankruptcy estate
- (2) The protection of US claimants against prejudice and inconvenience in the processing of claims in a foreign proceeding,
- (3) The distribution of proceeds of the estate substantially in accordance with the order prescribed by US law

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<sup>123</sup> Lynn M. LoPucki, ‘Cooperation in International Bankruptcy: A Post-Universalist Approach’ (1999) CORNELL L.REV. 696, 710.

<sup>124</sup> Ksenia V. Proskurchenko, ‘Chapter 15 Cross-Border Insolvency: Is It True to Its Universalism Aspirations?’ (2008) 5 *Rutgers Business Law Journal* 96.

<sup>125</sup> *Re Tri-Continental Exchange*, 349 B.R. 627, 634 (Bankr. E.D. Cal. 2006).

<sup>126</sup> *ibid*, 20; the UNCITRAL Guide, at para 196.

<sup>127</sup> *In re Artimm*, 335 B.R. at para 159.

<sup>128</sup> The section was about the conditions the court should be consider when decide whether to grand relief and assistance.

The first and third requirements both aim to emphasise the basic premises of the proceeding, which are just treatment and a legal distribution process. Only the second factor includes the element of local creditor protection, to safeguard against prejudice and inconvenience that the US creditors may face in the process of resolving claims in foreign proceedings. The court also clearly stated that the US courts should provide fair treatment to all claim holders in the insolvency context. Therefore, it could be seen that the US courts minimised the protection afforded to local creditors under the provision, and it offers much less protection than US creditors would have received in a domestic proceeding. This kind of protection has also been built into other articles of the Chapter. For example, under section 1507, which is about providing additional assistance to a foreign representative, the second limitation on the availability of additional assistance is for “protection of claim holders in the United States against prejudice and inconvenience in the proceeding of claims in such foreign proceeding”. This limitation could also be interpreted as that if foreign representatives want to get additional help from the US courts; they might have to offer US creditors additional protection. However, the language of this provision should have the similar intention of offering “sufficient protection”, which is to prevent local interests from prejudice and injustice in foreign proceedings. Therefore, the change under the US regime could be a terminological modification to retain consistency with former insolvency rules and avoid potential confusion in its legal history.

To sum up, as a legislative instrument, the Model Law allows alterations for incorporating it into domestic law, and it is good for its worldwide acceptance. However, it is natural that national laws would protect the interests of local citizens and businesses, so it is impossible to ask the national law to eliminate all its territorial elements. Based on the examples analysed above, the major objectives of those changes are to protect local creditors and interests. Since there are still a large number of countries that have not adopted the Model Law, those issues seem to have a good possibility of being considered when they are ready to reform their cross-border insolvency system. For some

countries, especially those who do not have a comprehensive legal system, adding certain extra protections for local interests seems necessary. The problem left to individual countries to answer is how far the protection could go without interfering in international efficiency and cooperation. Article 8, which emphasises the need to promote international uniformity in its application when interpreting the law, should always be remembered.

### **3.5 Conclusion**

In conclusion, since it is impossible to unify all domestic insolvency laws and a harmonised system is needed, the UNCITRAL Model Law intends to provide an instrument for individual jurisdiction to effectively solve cross-border insolvency cases. It was necessary, for the law to be acceptable in most jurisdictions, to leave some spaces and flexibilities so that domestic courts could make their own decisions on certain matters. As long as the decisions were made within the guidelines of the Model Law, the outcomes should be effective and acceptable for most of the involved parties. As a result, the negative influences of the flexibility also should be borne in mind in the application of the law. One of those influences is the divergent explanations of certain concepts of the law. The decision in *the Eurofood* case has had a significant impact on how to find the correct COMI location of an international company; however, the more flexible method adopted by the US court in this matter could reflect the objective of the Model Law. Taking into consideration various elements of the debtor in question would improve the correctness, and reflect the true COMI location. Furthermore, the US and the UK courts also interpreted “the appropriate relief” in different ways. While the UK court took a conservative attitude to limit the courts’ powers within the domestic laws, the US courts believe applying foreign law in certain circumstances is necessary for multinational matters. From those examples, it can be observed that both the UK and the US support the application of the Model law, but the US approaches are open-minded, which might be consistent with the objectives set up by the UNCITRAL. Also, some jurisdictions might manipulate the safeguard articles in order to protect local interests, which would compromise

the nature of cooperation; so, with such freedoms allowed by the law, finding the balance point between local protections and international cooperation is the key for the success of the Model Law. For other jurisdictions that have not adopted the Model law, current enacting countries' versions of the law will be their references; however, extra protection rules, as well as such reciprocity requirements and exclusive rules, might send the wrong signals and undermine the effectiveness of the law. Other countries should believe in the Model Law itself has efficient safeguards to avoid unfair situations. The EC regulation and the Model Law both adopted modified universalism; however, since they have different focuses and natures, mandatory international regulation can only work regionally, as in the European Union. Therefore, the UNCITRAL Model Law, working as a legal instrument under domestic laws, could be the appropriate international regime for solving cross-border insolvency.

## **Chapter 4 The Chinese Insolvency System and Its Approach to Solve Cross-Border Issues**

The essential role of a formal insolvency procedure is to provide a collective mechanism for all individual creditors to collect their debt. Without such a system, individual creditors would rush to pursue their debts on their own and probably cause damage to the value of the debtor's assets as a whole, which might harm their own interests, consequently.<sup>1</sup> As mentioned in the previous chapter, such an insolvency mechanism should be “effective and efficient”, which means it should maximise the value to creditors and ensure equitable distribution. Based on this internationally recognised idea, the Standing Committee of the National People's Congress passed a new version of the corporate insolvency law in 2006, the Enterprise Bankruptcy Law (“EBL”)<sup>2</sup>. To serve the developing market-oriented economy and the rapid globalisation of business trade, the new law includes a ground-breaking article dealing with issues of cross-border insolvency. However, the vague and imprecise language addressing cross-border insolvency issues could cause uncertainties in practice.

This chapter evaluates the Chinese cross-border insolvency system based on discussions of historical and political influences on the new bankruptcy law. The first part analyses the cultural and political influences on the bankruptcy system in China. Based on those influences, Part 2 briefly reviews the development of the Chinese bankruptcy system, focussing on the main features of the EBL, 2006. Part 3 considers how the new cross-border insolvency law under the new bankruptcy law was formed. Then, Part 4 focuses on the evaluation of the only article concerning cross-border insolvency issues, and its application in practice against the international principles and standards in solving international bankruptcy analysed in previous Chapters. The final section compares the Chinese system with the

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<sup>1</sup> Thomas H. Jackson, ‘Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors’ Bargain’ (1982) 91 *Yale Law Journal* 857, 861-868.

<sup>2</sup> Enterprise Bankruptcy Law of the People's Republic of China 2006.

UNCITRAL Model law to examine possible improvements in the Chinese cross-border insolvency system.

## 4.1 The Cultural and Political Influences

The concept of bankruptcy or insolvency has never been seriously recognised in the Chinese legal system. The traditional cultural thinking -“Son should pay the debts of the father” - has been the main solution for generations. The notion of bankruptcy or insolvency is always treated as ‘bad luck’ or ‘broken fortune’. The traditional Confucianism beliefs have also had a significant influence on the development of the insolvency system.<sup>3</sup> The Confucianism ethic promotes balance and harmony in society; therefore, people believe that court intervention should not be necessary until there are no other options.<sup>4</sup> Creditors prefer to rely on friendship and personal relationships with the debtor to solve debt issues, rather than forcing someone into involuntary insolvency. Cultural thinking leads to low regard in judicial solutions for insolvency, which could be one of the fundamental reasons why the development of a Chinese insolvency system has been so slow.<sup>5</sup>

Apart from cultural reasons, historical influences play a substantial role in the Chinese insolvency system. Following feudal times, the first official document regulating bankruptcy issues, called the Provisional Statute Governing the Liquidation of Merchants’ Debt, was published by the old Chinese government.<sup>6</sup> The system of regulation was modelled after Japanese and

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<sup>3</sup> Pauline Ma, ‘A New Chinese Bankruptcy System: Made for Business or for the State?’ (2000) 11 *Austl. J. Corp. L.* 192, 205; Traditional Chinese thinking is based on Confucian beliefs. Confucius philosophy was developed based on four elements: humanity, righteousness, propriety and wisdom, and its purpose is to build a harmonious society. See more detailed discussion: Tim Ambler, Morgen Witzel and Chao Xi, *Doing Business in China* (4<sup>th</sup> edn, Routledge 2017).

<sup>4</sup> *ibid.*

<sup>5</sup> Pauline Ma (n 3), 206; Nathalie Martin, ‘The Role of History and Culture in Developing Bankruptcy and Insolvency Systems: The Perils of Legal Transplantation’ (2005) 28 *Boston College International and Comparative Law Review* 1, 72.

<sup>6</sup> The old government means the government of The Republic of China (1925-1948),

German bankruptcy laws, and there was very little evidence for the application or effect of the law.<sup>7</sup> After the communist party established the new government, all the laws passed by the previous government were abolished, and all private enterprises became state-owned. For a long period, the state-planned economy system restricted the existence of an insolvency law because it was difficult to place a state-owned enterprise (SOE) into insolvency, as this would be treated as a failure of the government.<sup>8</sup> More importantly, the stability of SOEs is connected with public and social stability. Therefore, to analyse the development of the Chinese insolvency system, it is important to examine the role of SOEs in the Chinese economy first.

#### **4.1.1 The Role of State-Owned Enterprises (SOEs)**

After the establishment of the People's Republic of China, the communist party moved quickly to take control of real property, banking, industry, and commerce; during this process, private property was seized, and major factories and enterprises were nationalised or shut down.<sup>9</sup> The reason that the central government did this was to reorganise the limited amount of social resources after a long period of war, and to start nation-rebuilding tasks as soon as possible.<sup>10</sup> As a result, all commercial businesses and industries came under the ownership and control of the central government as state-owned enterprises (SOEs), which became the backbone of the Chinese economy.<sup>11</sup> During that time, SOEs played a dominant role in the Chinese economy, producing 80% of the national income for the manufacturing industry, with almost 70% of all industrial employees being hired by those enterprises.<sup>12</sup> There was no competition pressure or requirements for SOEs

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which was controlled by the Chinese Nationalist Party (Guo Min Dang 国民党).

<sup>7</sup> Leslie A. Burton, 'An Overview of Insolvency Proceedings in China' (2000) 6 *Annual Survey of International & Comparative Law* 113, 118.

<sup>8</sup> Nathalie Martin (n 5), 73.

<sup>9</sup> Ravi Bendapudi, 'People's Republic of China Bankruptcy Law' (2008) 6 *Santa Clara Journal of International Law* 205.

<sup>10</sup> Fan Gang and Nicholas C. Hope, 'The Role of State-Owned Enterprises in the Chinese Economy,' *China-US 2022* (2013), Chapter 16, 7.

<sup>11</sup> Ravi Bendapudi (n 9).

<sup>12</sup> NR Lardy, *China's Unfinished Economic Revolution* (Washington DC, Brookings,

to produce commercial profits; their only task was to meet planned production goals set by the central government.<sup>13</sup> SOEs could hardly go bankrupt under such a system. The political intention behind the idea of being without a bankruptcy system was to show “an attribute that made a socialist economy superior to its capitalist counterpart”.<sup>14</sup> ‘However, many SOEs suffered from enormous economic and social burdens, and this was one of the main reasons why the central government conducted economic reform in the 1980s. The reform partly opened up China’s market by eliminating certain socialist characteristics, and started the marketisation process of SOEs. While the core strategic industries, such as oil, electricity, and banking, were still tightly controlled by the central government, other industries were gradually or partially opened to private entrepreneurs and investors. In particular, the reform incorporated profit-oriented motive and corporate autonomy into Chinese SOEs, which provided the basis of the system for its significant economic growth after 1978.’<sup>15</sup>

Even when there were a few industrial SOEs liquidated during 1990s, the government had tight control over the whole proceedings. It means that the limited number of bankruptcy cases during the planned economy period had mainly been solved through administrative orders, instead of adhering to legal legislation. Because of the political intervention, the number of SOEs entering into bankruptcy proceedings is extremely small compared with the number of SOEs that were actually insolvent during that period in time.<sup>16</sup>

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1998) 25.

<sup>13</sup> Weijing Wu, ‘Commencement of Bankruptcy Proceedings in China: Key Issues in the Proposed New Enterprise Bankruptcy and Reorganisation Law’ (2004) 35 *VUWLR* 240.

<sup>14</sup> *ibid*, 243.

<sup>15</sup> Jewellord Nem Singh and Geoffrey C. Chen, ‘State-Owned Enterprises and the Political Economy of State-State Relations in the Developing World’ (2017) *Third World Quarterly* <<https://doi.org/10.108/01436597.2017.1333888>> accessed 25 September 2017.

<sup>16</sup> Lan Cao, ‘The Cat that Catches Mice: China’s Challenge to the Dominant Private Model’ (1995) 21 *Brooklyn Journal of International Law* 97, 172-173.

**Table 1: State Sector Employment as a Share of Total Urban Employment**

State Sector		State Sector		State Sector	
Year	Employment	Year	Employment	Year	Employment
	(% of total urban employment)		(% of total urban employment)		(% of total urban employment)
<b>1978</b>	78.3	<b>1997</b>	53.1	<b>2007</b>	21
<b>1980</b>	76.2	<b>1998</b>	41.9	<b>2008</b>	20.1
<b>1985</b>	70.2	<b>1999</b>	38.2	<b>2009</b>	19.3
<b>1990</b>	60.7	<b>2000</b>	35.0	<b>2010</b>	18.8
<b>1991</b>	61.1	<b>2001</b>	31.9	<b>2011</b>	18.7
<b>1992</b>	61.0	<b>2002</b>	28.9	<b>2012</b>	18.4
<b>1993</b>	59.8	<b>2003</b>	26.8	<b>2013</b>	16.6
<b>1994</b>	60.1	<b>2004</b>	25.3	<b>2014</b>	16.1
<b>1995</b>	59.1	<b>2005</b>	23.7	<b>2015</b>	15.4
<b>1996</b>	56.4	<b>2006</b>	22.7		

(Source: China Statistical Yearbook 2007, 2010, 2016)

Maintaining social stability was one of the main reasons to have tight control of the number of insolvencies among SOEs. “Social stability overwhelms everything else” was and probably still is a frequently voiced quote in Chinese political life.<sup>17</sup> Because of the dominant position of SOEs in Chinese society, they are the major employers for the urban population; from the 1950s to 1970s, around 80% of urban employment was offered by SOEs.<sup>18</sup> According to Table 1, it can be seen that the situation of SOEs as main urban employers

<sup>17</sup> *ibid*, 243.

<sup>18</sup> Xiangfeng Liu, ‘Response of SOEs (Stated-Owned Enterprises) to Economic Liberalisation in China’ (2006) V.R.F. Series No.415 <<http://www.ide.go.jp/English/Publish/Download/Vrf/pdf/415.pdf>> accessed 12 July 2016.

did not change until the late 1990s. Therefore, in addition to their main function of rebuilding the national economy, Chinese SOEs have been playing a vital role in providing a livelihood for the Chinese population.<sup>19</sup> Since there was no mature and separate social welfare system, for a period, working for SOEs was connected with social benefits including housing, medical care, pension and education services.<sup>20</sup> Under the socialist system, such a situation was called the “iron rice bowl”, which meant guaranteed employment with free benefits.<sup>21</sup> The government did not establish national pension and healthcare systems until the late 1990s; and during the same period, the SOEs provided 75% of urban housing and medical service for over 1/5 of the Chinese population.<sup>22</sup> Under such circumstances, the bankruptcy of SOEs was more about how to take care of unemployed workers and deal with other social issues connected with the bankruptcy, so it was more political than legal. The government’s big concern was that an unemployed and unprotected labour force might lead to strong political disaffection should the SOEs go into bankruptcy.<sup>23</sup> Hence, the government was extra careful when developing bankruptcy progress, and only allowed a small number of troubled SOEs to enter bankruptcy proceedings.<sup>24</sup>

Furthermore, another fact about Chinese SOEs during that time was there was a considerable amount of debt owed among different state enterprises since their businesses were traded on credit within connected enterprises.<sup>25</sup> So, the concern was that liquidation of one SOE would cause its creditor SOEs

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<sup>19</sup> Fan Gang and Nicholas C. Hope (n 10), 2.

<sup>20</sup> Ronald Winston Harmer, ‘Insolvency Law and Reform in the People’s Republic of China’ (1996) 64 (6) *Fordham Law Review* 2563.

<sup>21</sup> Hui He, Feng Huang, Zheng Liu and Dongming Zhu, ‘Breaking the “Iron Rice Bowl” and Precautionary Savings: Evidence from Chinese State-Owned Enterprises Reform’ (2014) Federal Reserve Bank of San Francisco Working Paper Series, 2014-04.

<sup>22</sup> World Bank, *Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System* (2001) 35 <<http://documents.worldbank.org/curated/en/2000/09/9866399/bankruptcy-state-enterprises-china-case-agenda-reforming-insolvency-system>> accessed 12 August 2016

<sup>23</sup> *ibid*, 35.

<sup>24</sup> *ibid*, 35-36.

<sup>25</sup> Ronald Winston Harmer (n 20), 2582-2583.

to become insolvent as well, which would be disastrous for the Chinese economic system.<sup>26</sup> The domino effect would also influence State-owned banks, which could be major creditors of many SOEs. The loans issued by banks in this period were usually based on compulsion from state orders rather than commercial operations, and the potential for enforcement was limited.<sup>27</sup> Since the debt would be written off by the government, the irrecoverable loans would cut down the assets of banks. It is estimated that one-fifth of state-owned banks' assets would disappear if all insolvent SOEs entered into bankruptcy proceedings.<sup>28</sup>

#### 4.1.2 The Role of Government in Insolvency Cases

The government interference in legal issues is another important feature in China. The notion is that government is the administrator of the socialist market economy, so it has the right to control and guide its development.<sup>29</sup> Traditionally, the government would have three different roles in the case of corporate insolvency.<sup>30</sup> Firstly, the government is a public administrator for general social activities. So its job is to coordinate the proceedings, and provide assistance that the courts require. The second role is as a participant in business activities. For instance, the government could be the major creditor of insolvent companies, or the actual manager of state-owned corporations. If those companies started insolvency proceeding, the government would have advantages in control of the whole proceedings, which could occasionally impair the role of the courts.<sup>31</sup> Lastly, the government could become the actual controller of the whole proceedings by

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<sup>26</sup> *ibid.*

<sup>27</sup> NR Lardy (n 12), 83.

<sup>28</sup> Shirley S Cho, 'Continuing Economic Reform in the People's Republic of China: Bankruptcy Legislation Leads the Way' (1994) 19 *Hastings Int'l & Comp L Rev* 739.

<sup>29</sup> Jianxin Huang and Feng Ding, 'The Research on the Role of Government in Insolvency Proceedings' (Tai Zhou Court Report 2016) <<http://www.tzcourt.gov.cn/e/action/ShowInfo.php?classid=64&id=3108>> accessed 20 September 2017.

<sup>30</sup> *ibid.*, see also Feiyue Shan and Daifu Lu, *The Necessary of Government Intervention: The Discussion based on Economic Laws* (Law Press 2005).

<sup>31</sup> Jianxin Huang and Feng Ding (n 29).

using its administrative power, and thus replace the courts. This might occur if the insolvent company is a big-scale business with a large number of employees and economic or social influences. The government wants to solve the insolvency as quickly as possible to protect employees' interests and reduce the negative influence in the market.<sup>32</sup> In practice, the government plays two, or even all three, roles in an insolvency proceeding, and the high level of interference in the legal proceeding reflects the long history of the government-planned economy in Chinese history.<sup>33</sup> During the period of the planned economy, both the Chinese legal system and the market system were just starting to develop, so the reality required the government to be part of the market regulation process.<sup>34</sup> Even today, since government-controlled investment or capital still play a very important role in the Chinese economy, it is difficult to expect that the government would give the court complete control of the insolvency proceedings. This is another main reason that the development of the Chinese insolvency system has been slow.<sup>35</sup>

To sum up, there are two main justifications for government interference in legal proceedings. Firstly, the development of the Chinese market economy needs direction and guidance from the government, and this is necessary to maintain the well-being of the market environment. Secondly, fostering a socialist society is the main purpose of the government, and the essence of such a society is harmonisation.<sup>36</sup> So the role of the government is to find solutions that will protect public interests. For those reasons, the theory of government intervention was developed and has played an important role in making the laws for the economy. The basic idea of the theory is to keep the balance of supply and demand through government intervention, and the non-

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<sup>32</sup> *ibid.*

<sup>33</sup> Dongxia Huang, 'The Analysis of the Relationship between Socialist Market Economy and Legal Culture' (2004) 9 *Information Review* 149.

<sup>34</sup> *ibid.*

<sup>35</sup> Weiwen Yang, Feitao Jiang and Mingqing Li, 'Government Behaviours and Roles in Corporate Insolvency' (2001) *Journal of Central South University of Technology* 50

<sup>36</sup> Xiaoping Jin, 'The Study on the Role of Local Government in Corporate Insolvency' (PhD Thesis, Southwest University of Political Science and Law).

market-driven balance is necessary for developing a healthy economy.<sup>37</sup> It is clear that the Chinese insolvency law and its application in practice could be a good example of the influence of the theory.

It should be noted that the balance does not mean that the government would make all the insolvent companies disappear as soon as possible. In some cases, the intervention of government might help some companies get a second chance. For example, the business of the insolvent company may be related to some government projects or in the industry that the local government is trying to encourage, and the government would be willing to rescue such companies with flexible standards. Since their financial difficulties and bad loans make it impossible to get any help from financial institutions, the government would persuade local banks or new investors to help.

## **4.2 The Overview of Chinese Insolvency System**

### **4.2.1 1986 Enterprise Bankruptcy Law and Other Relevant Regulations**

The communist government did not produce its first formal corporate bankruptcy law until the early 1980s, during the period of China's transition from a government-planned economy to a market-oriented economy, which led to the approval of 1986 Enterprise Bankruptcy Law.<sup>38</sup> This law was designed with the specific purpose of only applying to SOEs, and it was officially implemented in 1988 after the reform of the state-owned enterprise sector. The process of making the Chinese first bankruptcy law caused one of the most furious debates in Chinese legislative history.<sup>39</sup> Overall, excessive regulations and state intervention were the two major features of the first

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<sup>37</sup> Changlin Li and Maoqin Huang, 'The Spatiality of Economic Law' (2002) 24 *Modern Law Science* 3.

<sup>38</sup> The Enterprise Bankruptcy Law of the People's Republic of China (trial Implementation), 1986.

<sup>39</sup> Donald C Clarke, 'What's Law Got to Do with It? Legal Institutions and Economic Reform in China' (1991) 20 *UCLA PAC Basin LJ* 51.

bankruptcy law in China.<sup>40</sup>

Under this law, an SOE could only apply for insolvency with the approval of the government,<sup>41</sup> and it was impossible for certain enterprises that had a close connection with the national economy and public interests to enter into insolvency proceeding.<sup>42</sup> The most important positive effect of the 1986 Bankruptcy law was to bring in the necessary changes in attitude towards corporate insolvency among Chinese SOEs.<sup>43</sup> Such changes were deemed to be essential to create a socialist market economy. Heavy social obligations and a lack of commercial basis made it difficult for them to achieve profitability.<sup>44</sup> SOEs with poor financial performance had gradually become a huge burden on the government as the government and state banks always had to be responsible for their debts. The introduction of the bankruptcy law made the SOEs realise that insolvency could be possible, and the underlying aim was to encourage SOEs to be more productive and self-sufficient.<sup>45</sup> Also, by forcing the SOEs to be more responsible for their debts, the law encouraged mergers and takeovers among SOEs, which facilitated the modernisation of the Chinese market.

However, although the government had realised that bankruptcy reform was relevant to the entire economic system, social stability and political concerns were still the top priorities.<sup>46</sup> So, the adoption of the law was more for symbolic reasons rather than its power to solve economic or legal issues.<sup>47</sup> Its

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<sup>40</sup> *ibid*; Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws, Perspectives and Principle' (2008) 8 (1) *Journal of Corporate Law Studies* 113.

<sup>41</sup> Article 17, The Enterprise Bankruptcy Law 1986 (China).

<sup>42</sup> Chuyi Wei, 'Chinese Bankruptcy Law in its Eight Years: An Evaluation in Theory and Practice' (2014) *International Company and Commercial Law Review* 309.

<sup>43</sup> Roman Tomasic *et al*, 'Insolvency Law Administration and Culture in Six Asian Legal Systems' (1996) 6 *Australian Journal of Corporate Law* 248, 251.

<sup>44</sup> Rebecca Parry and Haizheng Zhang (n 40).

<sup>45</sup> *ibid*.

<sup>46</sup> Roman Tomasic and Zinian Zhang, 'The Political Determinants of Corporate Reorganization in China', in Antons, C, (ed.) *Routledge Handbook of Asian Law* (Routledge 2016) 125.

<sup>47</sup> Sherry Miller, 'Institutional Impediments to the Enforcement of China's Bankruptcy Laws' (1996) 8 *International Legal Perspective* 187, 189.

language and application were mainly focused on political objectives, and not on fairness and efficiency.<sup>48</sup> For this reason, there were very few situations that allowed an SOE to apply for insolvency proceedings under that law. Even if an insolvency proceeding was permitted, the government would usually place the employees at the top of the creditors' priority ranking for purposes of social stability; as a result, some major creditors with security, such as banks, could only recover a small number of their claims.

Apart from the 1986 Enterprise Bankruptcy Law, the issues of private corporate bankruptcy were regulated in other commercial or civil laws over this period. The Code of Civil Procedure Law was passed in 1991,<sup>49</sup> and Chapter 19 regulates the procedure for bankruptcy repayment of enterprises as legal persons; the aim was to provide some private sector bankruptcy legislation, and to remedy the lack of coverage for non-SOEs under the 1986 Bankruptcy law. However, the Chapter contains only seven brief articles that could not solve specific issues. Because of the restricted development of non-state-owned businesses during that time, the application of Chapter 19 was limited.

Another type of bankruptcy regulations should be mentioned; those created as provincial laws. Regulation concerning bankruptcy was made for the Shenzhen Special Economic Zone.<sup>50</sup> This regulation reflected some features of a modern bankruptcy law system, stating that the purpose of the regulation is to protect the market economy in the economic zone.<sup>51</sup> Other relevant regulations and administrative documents related to bankruptcy issues offered some general explanations, but political statements were also included, emphasising the dominating position of state-owned enterprises, and making

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<sup>48</sup> John J Rapisardi and Binghao Zhao, 'A Legal Analysis and Practical Application of the PRC Enterprise Bankruptcy Law' (2010) 11 *Bus. L. Int'l* 49.

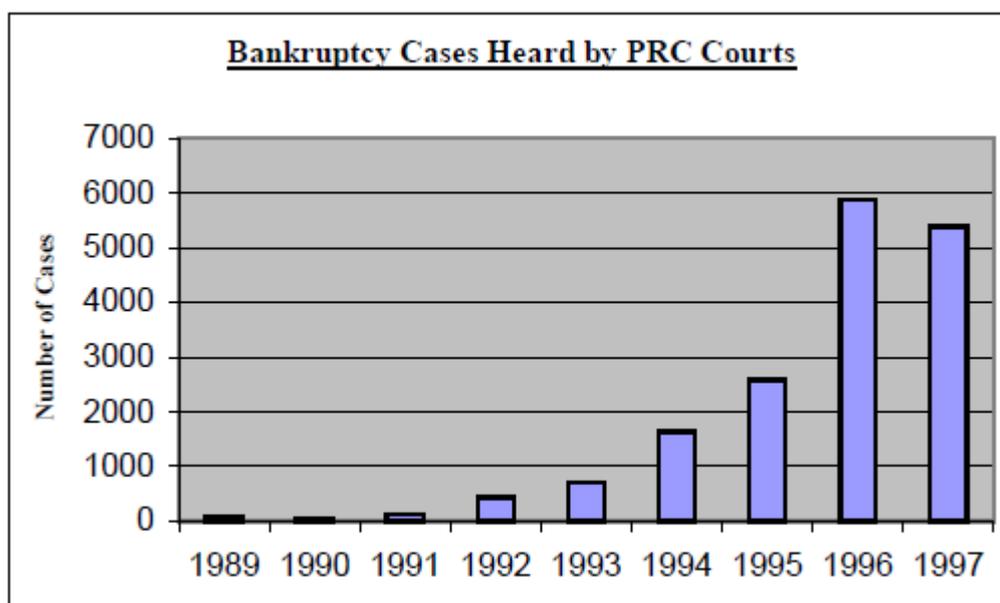
<sup>49</sup> Chapter 19 Procedure for Bankruptcy and Debt Repayment of Legal Person Enterprises, Civil Procedure Law of the People's Republic of China 1991.

<sup>50</sup> Shenzhen was the first Special Economic Zone of China following the "opening up" policy, which established to attract foreign investment and multinational companies.

<sup>51</sup> Article 1, Regulation of Shenzhen Special Economic Zone on Enterprise Bankruptcy 1993 (Repealed in 2012).

sure political objectives came first in solving bankruptcy. For example, State Council Directive 1994 required that the priority in a case of enterprise bankruptcy was to “resettle the employees to maintain order and stability in the society”.<sup>52</sup>

**Figure 1: Corporate Bankruptcy Cases Heard by PRC courts**



(Source: The World Bank 2000)

To sum up, the bankruptcy system during this period included one primary law for state-owned businesses, the 1986 Enterprise Bankruptcy Law, with other policy documents that regulated the application of the law; other minor laws directed other types of bankruptcy. All those laws were very diverse and could not form a unified system for solving bankruptcy, with political objectives being the main cause of the situation. With the significant discretion of the authorities in the bankruptcy process, it can be observed from the chart that there were only a few filed corporate bankruptcy cases between 1989 and 1993, which amounts to around 277 cases per year, based on the research from the World Bank.<sup>53</sup> Although the bankruptcy system was flawed during that time, the

<sup>52</sup> Part 1, State Council Directive on the Relevant Issues concerning the Pilot Implementation of Bankruptcy of a State-Owned Enterprise in Some Cities, No.59 (1994) of the State Council (China).

<sup>53</sup> The World Bank, Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System. <<http://documents.worldbank.org/curated/e>

number of corporate bankruptcy cases increased rapidly in 1996-1997, to around 5000 cases per year.

Moreover, there were no provisions in that law to address the insolvency issues with foreign elements. The legal development of insolvency provisions for foreign-related businesses originated in some province-level regulations. At that time, most of those regulations were more about the permitted business models that the private or foreign enterprises could use, or the conditions for starting such businesses, which were too ambiguous to deal with specific foreign insolvency proceedings.

#### **4.2.2 The Development of the New Law**

Under the tight control of the government, SOEs were not independent economic entities but more like production units owned by the state.<sup>54</sup> To facilitate further development of the market economy and globalisation, the Chinese government conducted the corporatisation of State-owned Enterprises in the 1990s. In essence, the process made the state become the sole shareholder, and private investors were allowed to invest in certain industries.<sup>55</sup> Most companies transferred to corporations with an independent legal personality through this process; consequently, the Bankruptcy Law 1986 was no longer applicable after the transition. Moreover, due to the reduced restrictions and encouragement policies on private enterprises, the Chinese private sector had expanded considerably since the 1990s. The private sector started to develop during the 1980s, and by 2005, before the new bankruptcy law was introduced, the number of private

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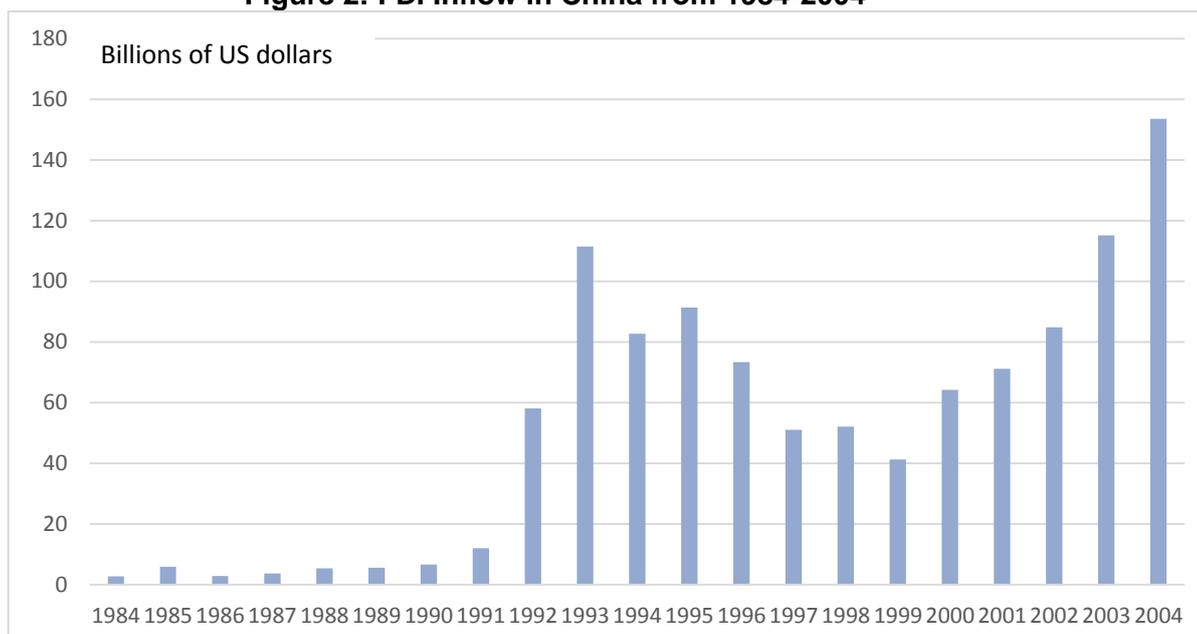
n/2000/09/14451105/bankruptcy-state-enterprises-china-case-agenda-reforming-insolvency-system> accessed 20 July 2015: The report was released in 2000, and the aim of the research was to provide practical advices for the making of the Enterprise Bankruptcy Law 2006.

<sup>54</sup> Rebecca Parry and Haizheng Zhang (n 40), 115; Jiangyu Wang, 'The Political Logic of Corporate Governance in China's State-owned Enterprises' (2014) 47 *CORNELL INT'L L.J.* 631.

<sup>55</sup> Lilian Miles and Zhong Zhang, 'Improving Corporate Governance in State-Owned Corporations in China: Which Way Forward' (2006) 6 (1) *Journal of corporate law studies* 2013, 216.

enterprises accounted for 61% of a total number of registered enterprises.<sup>56</sup> The major banks, as the important financiers for most private enterprises, required a more effective corporate insolvency system to protect their interests. Apart from those internal developments, economic and political pressures from other countries also pushed the reform in the area of commercial law. Foreign investment had significantly increased in both public and private areas since the 1990s, as shown in figure 2. One example of political pressure was from the World Trade Organisation. During the negotiation for joining the organisation, many member states indicated their concerns about the Chinese economic model and the commercial law system, and refused to recognise China as having market economy status.<sup>57</sup> In light of both internal and external pressures, reform of the bankruptcy regime to govern all different types of corporations, and reflect the global developments, was unavoidable.

**Figure 2: FDI Inflow in China from 1984-2004**



(Source: China Ministry of Commerce)

<sup>56</sup> National Bureau of Statistics of the People's Republic of China, Main Data Report of the First Economic Census (2005) <[http://www.stats.gov.cn/tjsj/tjgb/jjpcqb/qgjjqgb/201407/t20140731\\_590160.html](http://www.stats.gov.cn/tjsj/tjgb/jjpcqb/qgjjqgb/201407/t20140731_590160.html)> assessed 21 September 2017.

<sup>57</sup> WTO, Report of the Working Party on the Accession of China, WT/ACC/CHN/49, October 2001, para 151 <<https://docsonline.wto.org/dol2fe/.../DirectDoc.aspx?...t%3A%2Fwt%2Facc%2Fchn49>> accessed 12 June 2017.

From the first mention of bankruptcy law reform in a national conference in 1993 to the final approval by the People's Congress in 2006, it took thirteen years to make the EBL 2006.<sup>58</sup> The major difficulty of the long process was how to deal with financially troubled enterprises in order to satisfy both the need of supporting the developing market economy and the aim to protect social and welfare interests during the political transition period. The arguments were focused on problems such as whether the SOEs should be governed by the new law, or whether the employees' claim should take priority over secured priority. However, facing both internal and external pressures in needing a modern bankruptcy system, the government put more efforts into the reform, and put more pressure on involved parties, so compromises were achieved.

The new bankruptcy law received positive comments from western commentators, and was hailed as a market-oriented statute. Professor Charles Booth stated that the new Chinese bankruptcy law had significantly clarified and simplified the insolvency regime in China, and the goal of providing a harmonised and unified law for various processes had been accomplished.<sup>59</sup> Professor Parry believes that the reform of the law potentially could have a huge impact in contributing to the development of the socialist market economy following the reduction in government interference in the market and bankruptcy process. Since the reform of the law was promoted by both Chinese scholars and global forces, the process of drafting the law received active assistance from major international organisations such as the World Bank, the Asia Development Bank, WTO and the UNCITRAL. The World Bank and UNCITRAL were the key forces in pushing the global trend of bankruptcy law reform. The final formation of EBL 2006 was developed based on Chinese cultural and national conditions, and also drew references from established experiences of other countries and international

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<sup>58</sup> The law was passed by the National People's Congress on August 2006, and came into effect on June 2007.

<sup>59</sup> Charles Booth, 'The 2006 PRC Enterprise Bankruptcy Law: The Wait Is Finally Over' (2008) 20 *Singapore Academy of Law Journal* 275, 283.

organisations.<sup>60</sup> Professor Jingxia Shi emphasised that the drafter took a “made in China” approach, and had not directly relied on foreign insolvency regulations.<sup>61</sup>

#### **4.2.3 Major Improvements under the EBL 2006**

The objective of the law was set down in Article 1, as “fairly settling claims and debts, safeguarding the lawful rights and interests of creditors and debtors, and maintaining the order of the socialist market economy”.<sup>62</sup> Compared with the 1986 version, the EBL had made major improvements.

One main objective of the new law was to harmonise the disconnected bankruptcy systems under different laws, and it was accomplished, to a great extent. According to Article 2, the law applies to all enterprises with legal person status, which replaced and simplified the system that state-owned and non-stated-owned enterprises were governed by different legislation.<sup>63</sup> However, because of the dominant position of state-owned enterprises in the Chinese market, there were long-lasting discussions and research about how the new law should be applied to SOEs. In practice, certain SOEs that engaged in businesses that have a major connection with national security or social stability, such as mining or military, are excluded from the scope of the new law. Additionally, the basic filing criteria are clearer than in the previous law, which now provides that a bankruptcy application can be filed in the People’s Court in the debtor’s place of residence if the business entity is either unable to repay the debts that fall due and assets are insufficient to repay debts in full, or it is obviously insolvent.<sup>64</sup> The criteria adopted a combination

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<sup>60</sup> Zhijie Jia, ‘Explanatory Notes of the Draft of the Enterprise Bankruptcy Law: the 10<sup>th</sup> National People’s Congress of China on 21<sup>st</sup> June 2004’ <[http://www.npc.gov.cn/wxzl/gongbao/2006-09/26/content\\_5354979.htm](http://www.npc.gov.cn/wxzl/gongbao/2006-09/26/content_5354979.htm)> accessed 10 October 2017.

<sup>61</sup> Shi Jingxia, ‘Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China’s Transition to a Market Economy’ 2007 (16) *Norton Journal of Bankruptcy Law and Practice* 645, 655.

<sup>62</sup> Article 1, EBL 2006.

<sup>63</sup> Article 2, EBL 2006.

<sup>64</sup> Article 2, EBL 2006.

of the balance sheet test and cash-flow test.<sup>65</sup>

Another major improvement during the reform of the new law was the introduction of the role of the administrator, which should be a professional and independent individual or organisation appointed by the court from the date the case is accepted.<sup>66</sup> In the past, the relevant government department always played the administrative role during bankruptcy, and for cases of non-SOEs, the professionals usually played a minor role during the proceedings. The administrators play a major role in the bankruptcy processes under the new law; they have the power not only to manage the daily expenses of the debtor, but also to decide, distribute and dispose of the debtor's assets. Furthermore, the administrator can ask the court to revoke transactions conducted up to one year before the filing of bankruptcy, if such transactions involved situations listed in the law. With a wide range of responsibilities, the efficiency of those processes will depend on the performance of the administrator.<sup>67</sup>

Following the international trend, corporate rescue was one important topic in the reform of bankruptcy law.<sup>68</sup> There were some provisions about corporate reorganisation in past laws, but most of them were very general, and not practical in practice.<sup>69</sup> Under the new law, there are two chapters for regulating the procedures for reorganisation and conciliation.<sup>70</sup> Both the debtor and creditor have the right to apply for reorganisation, which only applied to SOEs with government approval in the past. The chapter on conciliation has more detailed regulations about the process and the agreement. In designing those procedures, the lawmakers used the

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<sup>65</sup> Samuel L. Bufford, 'China's Bankruptcy Law Interpretations: Translations and Commentary' (2017) 91 *American Bankruptcy Law Journal* 1, 15.

<sup>66</sup> Chapter 3, EBL 2006.

<sup>67</sup> General discussion on administrator under Chinese law, see Charles D Booth (n 60) 232-300.

<sup>68</sup> Zinian Zhang and Roman Tomasic, 'Corporate Reorganization Reform in China: Findings from an Empirical Study in Zhejiang' (2016) 11(1) *Asian Journal of Comparative Law*.

<sup>69</sup> *ibid*, 311.

<sup>70</sup> Chapter 8 Reorganisation, Chapter 9 Conciliation, EBL 2006.

insolvency systems in advanced jurisdictions as references. For example, the reorganisation proceeding shares similarities with the reorganisation procedure set by the US Bankruptcy Code, and the administration under the UK Insolvency Act; the conciliation process reflects the voluntary arrangements for settlement from English law, which is about reaching an out-of-court solution between the debtor and creditors. Although these chapters still need judicial interpretations and more supporting laws, it is a noticeable improvement in the Chinese law.

The other evident improvement under the new law is the provision of unified priority rules for distribution. Although the 1986 bankruptcy law regulated that secured creditors enjoy priority over unsecured creditors, which was followed, in order, the employees' salary and insurance, taxation, and other unsecured claims, some government orders might require a different priority scheme during that time. For example, some might regulate that some workers' resettlement rights, or certain pension and medical interests, should be satisfied before secured claims. The new law made it clear that the secured rights would be protected before the payment of employees' claims.<sup>71</sup> Nevertheless, the law still added some further extra protection for employees. For instance, one of the general principles is the protection of employees' legal rights.<sup>72</sup> It also requires a provisional plan that explains the resettlement plans for employees, and the repayment plans of salaries and social insurance when the debtor submits the bankruptcy petition. Furthermore, if the creditor has filed the bankruptcy petition, such documents should be submitted to the court within 15 days by the debtor.<sup>73</sup>

Cross-border insolvency constituted another major improvement, and the detailed discussions and developments about the issue during the reform will be discussed later in this chapter.

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<sup>71</sup> Article 113, EBL 2006.

<sup>72</sup> Article 6, EBL 2006.

<sup>73</sup> Article 11, EBL 2006.

#### 4.2.4 The Inherited Factor: Government Interference

Although the Chinese government has been active in pushing legal reform in the business sector in support of the rapidly expanding economy, it is unrealistic to expect a total market-oriented legal system being adopted in the foreseeable future. Historically, Chinese governments have not encouraged private commercial activities because of the policy of national isolation and centralised governmental control.<sup>74</sup> It means that there has not been enough protection for private businesses, which has led to the situation where the public commercial sector has always been tightly controlled by the state, and private enterprises operated on the secure basis of family connection or social relationship rather than formal bodies of law.<sup>75</sup> Therefore, it might be naive to think that the scope of government intervention in the bankruptcy system would be eliminated by just reforming some laws.

Under the previous law, government approval was required at every stage of the bankruptcy process, especially by the local government in the city or province where the insolvent company was located. The bankruptcy committee appointed by the court included officials from local relevant government departments. Although there is no doubt that the EBL 2006 is a major improvement in Chinese corporate law history, the factor of state interference has been inherited. Since this was the first modernised insolvency regime in China, and not all industries have been commercialised like western countries, it was expected that the state would want to leave some space to balance commercial and political considerations.<sup>76</sup> Even though some concepts of the EBL were borrowed from advanced regimes such as Germany and the US, its application depends on what role is assigned

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<sup>74</sup> Roman Tomasic and Jenny Fu, 'Company Law in China' in Roman Tomasic (ed.) *Company Law in East Asia* (Ashgate, Aldershot 1995) 135.

<sup>75</sup> *ibid*, also Angus Young, Grace Li and Alex Lau, 'Corporate Governance in China: The Role of the State and Ideology in Shaping Reforms' (2007) 28 (7) *Company Lawyer* 204, 206.

<sup>76</sup> Soogeun Oh, 'Comparative Overview of Asian Insolvency Reforms in the Last Decade' (2006) the Fifth Forum for Asian Insolvency Reform, OECD.

to the law.<sup>77</sup> While developed jurisdictions apply insolvency law as the instrument to achieve effective distribution for creditors as a whole, China sometimes takes political considerations over efficiency.<sup>78</sup> As stated at the beginning of the new law, maintaining the order of a “socialist” market economy is the main role of the law, so the government role stands for the socialist part. Consequently, there is some vague language in the law which could be used by the state to influence the legal proceedings.

The first example of this is the commencement of the insolvency proceedings under the law.<sup>79</sup> Unlike some advanced jurisdictions where an insolvency case formally commences upon the application to the court, under the EBL, an insolvency case starts when the court decides to accept the application. There is a 15 day gap between filing the application and the court making a decision. Therefore, there is space for intervention since the law does not provide the conditions the court will consider in deciding whether to accept the case. Apart from the commencement of the process, the government can also influence the bankruptcy by directly participating in the process. The law states the administrator can be an interim liquidation committee, consisting of qualified lawyers, certified public accountants, or other social intermediary agencies.<sup>80</sup> Based on interpretation, the members of the committee can be appointed from relevant departments of the government, and from intermediary social agencies, including financial asset management companies, the People’s Bank, and financial regulatory institutions, under relevant laws and administrative regulations.<sup>81</sup> A similar article and application can also be found under the old bankruptcy law.<sup>82</sup>

The court’s decision can be influenced by the government for different reasons.

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<sup>77</sup> Chuyi Wei (n 42), 312.

<sup>78</sup> *ibid.*

<sup>79</sup> Article 10, EBL 2006.

<sup>80</sup> Article 24, EBL 2006.

<sup>81</sup> Article 19, Provisions on Designating the Administrator during the Trial of Enterprise Bankruptcy Cases, Interpretation No.8 [2007] by the Supreme People’s Court.

<sup>82</sup> Article 24, Enterprise Bankruptcy Law 1986 (China).

In some cases, government involvement will be used as an instrument during the bankruptcy.<sup>83</sup> The local government may be willing to pay some part of the debtor's debts, or force the debtor to conduct reorganisation, if the bankruptcy could cause serious influences on local employment and the economy. In some other cases, local governments get involved in bankruptcy cases simply because they do not want negative appraisals or reputation since the local economy is connected to their political performance. However, even though the interferences might have positive intentions in some cases, it still disrupts the functioning of the market mechanism, and can conflict with the principle of fairness and equality enshrined in the bankruptcy law.<sup>84</sup> Specifically, the creditors' interests are usually damaged; for example, the government may force creditors to accept an unfair reorganisation plan to reduce the disruption to the local community.

In summary, there is a long history and tradition that government plays an important role in bankruptcy cases for economic or political purposes. Such a tradition will not be changed in the near future, and it is important to find a balance between political objectives and legal fairness in a market-oriented environment. Obviously, the government would be more cautious in dealing with bankruptcy cases with international elements; therefore, for this research, the government factor will be an essential consideration in this and following chapters.

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<sup>83</sup> Chuyi Wei (n 42), 315.

<sup>84</sup> *ibid.*

## 4.3 The Development of a Cross-Border Insolvency Law in China

### 4.3.1 Slow Development at Regional Level

The legislation on cross-border insolvency issues was a total blank before the introduction of the EBL 2006. The bankruptcy chapter under the Civil Procedure Law may apply to a foreign-related legal person, but it did not address any detailed issues.<sup>85</sup> Other regulations on the enterprise with foreign elements were also quiet in this area. Traditionally, the Chinese courts conducted the territoriality approach when facing inbound cross-border insolvency issues.<sup>86</sup> In an early case, *Liwen District Construction Company*,<sup>87</sup> the Chinese court refused to recognise the appointment of a Hong Kong representative, and as he could not represent the Hong Kong company in the Chinese proceeding, so the representative could not be granted powers that a liquidation committee would have had under EBL 1986. The intention was to protect Chinese parties' rights and control the assets located within China, which reflects the protective tradition for dealing with international issues in Chinese courts.

Regarding outbound transactions, the first effort to address the problem with foreign elements at the national level was conducted by the Supreme People's Court in 2002.<sup>88</sup> The judicial interpretation was passed to clarify uncertainties of insolvency provisions under various national laws, and to avoid possible conflicts in insolvency proceedings.<sup>89</sup> Article 73 simply stated that a liquidation team would be appointed to pursue the assets of insolvent

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<sup>85</sup> Jingxia Shi, 'Chinese Cross-Border Insolvencies: Current Issues and Future Developments' (2001) 10 *International Insolvency Review* 33.

<sup>86</sup> Charles D Booth (n 59), 313.

<sup>87</sup> *Liwan District Construction Company v Euro-America China Property Ltd*, see Donald J Lewis and Charles D Booth, 'Case Digest' (1990) 6 *China Law and Practice* 27.

<sup>88</sup> Provisions of the on Some Issues Concerning the Trial of Enterprise Bankruptcy Cases, interpretation No 23 [2002] by the Supreme People's Court.

<sup>89</sup> The aim of the document was set in the first paragraph, which was to assist the Corporate Bankruptcy Law 1986.

Chinese debtors that were located outside the borders of China, which confirmed the extraterritorial power of the Chinese law. But, there was no detailed explanation about how the system would work. Although the document was the official interpretation of the EBL 1986, there was no matching Article about extraterritorial effect under the law. In practice, the recovery of foreign assets would have to depend on the application of foreign law, so the effect of this article was in doubt. The intention of article 73 was to be a facilitating assistant article for Chinese liquidators recovering overseas assets, and was an early demonstration that the government had noticed the issues of cross-border insolvency.<sup>90</sup> Nevertheless, those traditional attitudes and territorial approaches to solving inbound and outbound cases have been inherited in the development of the cross-border insolvency law under the new bankruptcy system.

Interestingly, the early development of the cross-border insolvency law started at the provincial level, after the government introduced an opening-up policy and established Special Economic Zones. Those regional approaches and regulations reflected the features of protectionism and territorialism mentioned above. There was one article addressing the issue of foreign-related enterprises in the Bankruptcy Regulation of the Shenzhen Special Economic Zone which stated that the intermediate people's courts of Shenzhen province had jurisdiction over any assets of foreign debtor located within the area, and bankruptcy proceedings opened by Chinese courts within the area should have jurisdiction over all the assets of the debtor, wherever they are situated.

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#### **4.3.2 The First Case of Recognising Foreign Judgment**

In the same year of the introduction of the judicial interpretation, an important case, known as the *B&T case*<sup>92</sup>, was heard by Guangdong (SEZ) Foshan

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<sup>90</sup> Charles D Booth (n 59) 311.

<sup>91</sup> Article 5, Bankruptcy Regulations of Shenzhen Special Economic Zone on Companies with Foreign Investment 1986 (China).

<sup>92</sup> The case was not officially reported. Jingxia Shi, 'Chapter 17 Cross-Border Insolvency', in Rebecca Parry, Yongqian Xu and Haizheng Zhang (ed.), *China's New*

Intermediate court, and it was the first case in which a Chinese court granted recognition of a foreign insolvency judgment. In this case, Nanhai Pioneer Mould was a joint venture formed in 1993 by a Chinese company, Nanhai Jili Ceramic Industry and its Italian partner, Nasseti Ettore s.p.a. The Italian company was declared bankrupt according to No. 62673 judgment issued by the Milan court. B&T, another Italian company, won the bid on purchasing the assets of the insolvent debtor, so the Civil and Penal Court in Milan issued an order requiring the administrator to transfer all assets to the purchaser, B&T, for its freedom of control. However, after the bankruptcy, the Italian company reached an agreement on share transfer with a Hong Kong company, which became the foreign partner of the joint venture after the Nanhai Foreign Economic and Trade Bureau approved the agreement. B&T filed a petition to Chinese court applying for recognition of the Italian bankruptcy judgment and claimed itself as the only legitimate holder of the shares of the joint venture; so the transfer was illegal since it was conducted by the debtor after the bankruptcy. During that time, the recognition and enforcement of foreign judgment were governed by Civil Procedure Law,<sup>93</sup> and the foreign party had the right to apply directly to the intermediate court of China, which had jurisdiction. After examining the facts of the case, the court stated the recognition of the Italian judgment would not violate the basic principle of Chinese law or damage its sovereignty, safety, and social interests; furthermore, the recognition met the requirements set by the Treaty on Judicial Assistance in Civil Matters between China and Italy.<sup>94</sup> Therefore, the bankruptcy order made by the Milan court would be honoured in China.

Because this was the first recognition of a foreign insolvency judgment, it is a significant landmark in Chinese legal history, and could be treated as an indicator for cross-border insolvency issues; and although the Chinese courts

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*Enterprise Bankruptcy Law: Context, Interpretation and Application* (Routledge 2010); also Haizheng Zhang and Ran Gao, 'An Analysis of Cross-Border Insolvency in China's New Bankruptcy Law: A Big Step Forward' (2011) 8 (2) *International Corporate Rescue* 93, 95.

<sup>93</sup> Article 267, 268, Civil Procedure law 1991 (China).

<sup>94</sup> This treaty was concluded on 20 May 1991 between China and Italy, approved by the Standing Committee of the National People's Congress on 1 July 1992.

do not have the principle of binding precedent like a common law system, the courts' considerations towards recognition of foreign insolvency still could be observed. Firstly, one of the important bases for recognising a foreign judgment is the presence of international treaties, which is the foundation of recognition in this case. The ideal situation would be there is a treaty or relationship based on the treaty (such as the principle of reciprocity) between the jurisdiction concerned and China. Otherwise, it could be difficult for a Chinese court to recognise without such an arrangement since mutual respect and assistance is one of the essential requirements when Chinese courts deal with international issues. The second point the court would focus on is the effects following the recognition. If the recognition were to infringe on the public values of China, such as state sovereignty, security or social interests, the court would not grant it. However, there are no detailed interpretations of terms like social interests or basic principles of Chinese law under the Civil Procedure law, or other laws.

#### **4.3.3 The Making of Article 5 under EBL 2006**

The first draft of the new bankruptcy law was submitted to the National Congress in 1995, but it did not pass because of a lack of supplementary regulations and an effective social insurance system.<sup>95</sup> Under this draft, there was one simple sentence addressing cross-border insolvency, which stated the bankruptcy proceedings initiated in foreign jurisdictions should have no effect on the debtor's assets located in China, and the bankruptcy proceeding commenced by Chinese Courts shall have an effect on the debtor's assets located outside of the territory of China.<sup>96</sup> This proposed article sticks to the purely territorial approach, and the straightforward language reflects the lack of understanding of complicated problems linked to cross-border insolvency.<sup>97</sup>

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<sup>95</sup> Zhijie Jia (n 61), Explanatory Notes to the National People's Congress.

<sup>96</sup> Article 7, Enterprise Bankruptcy Law of PRC (draft) 1995.

<sup>97</sup> Immanuel Gebhardt and Kerstin Olbrich, 'New Developments of Chinese Bankruptcy Law Reform', in Shaoping Zhu and Jun Ge (ed.), *The Bankruptcy Law of the People's Republic of China: Materials on the Drafting Process 2000* (CITIC Publishing House 2000).

With recommendations from advanced jurisdictions and international organisations, it was suggested that a territorial approach was not consistent with the international trend. Hence, the article on cross-border insolvency received more attention after 2000. The 2002 draft adopted certain principles of universalism. Article 8 of the 2002 draft kept the extraterritorial effect of the Chinese law, which provided that the new law would apply to debtors' assets outside of China too.<sup>98</sup> Relying on this effect, the Chinese representatives would have a legal basis in seeking recognition and cooperation overseas.<sup>99</sup> Also, this draft also addressed the conditions on recognition of foreign proceedings, which states:

*if a foreign bankruptcy proceeding is seeking recognition or enforcement in China, the Chinese court may grant the approval of the subject in the following situations:*

- 1) If there is no relationship based on treaties or reciprocity agreements between China and the foreign jurisdiction where the proceeding is opened*
- 2) If the recognition will violate the public interests of China*
- 3) If the recognition will violate the lawful interests and rights of Chinese creditors*
- 4) Other necessary factors that Chinese courts recognise ought to be taken into consideration*

The language of this article would be likely to give the court a greater level of discretion in deciding whether to grant the recognition.<sup>100</sup> Specifically, even if the foreign proceeding meets the first three requirements, the court could still reject it based on the “necessary factors” in subsection 4. The ambiguous

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<sup>98</sup> Article 8, Enterprise Bankruptcy Law of PRC (draft) 2002; Jingxia Shi, 'A Summary of Positions on Cross-Border Insolvency in China' (International Insolvency Institute) < [http://www.iiiglobal.org/sites/default/files/8-\\_China\\_on\\_Cross.pdf](http://www.iiiglobal.org/sites/default/files/8-_China_on_Cross.pdf) > accessed 12 September 2017.

<sup>99</sup> Charles D Booth (n 59) 313.

<sup>100</sup> Jingxia Shi (n 98).

choice of the words would also give the government an opportunity to interfere. Therefore, to avoid the uncertainties and facilitate better international cooperation, subsection four was deleted in the final version. Besides this, the sentence “Chinese court *may* grant approval” was changed to “Chinese courts *shall* grant approval”, which was intended to encourage international cooperation.

So, in the final version, cross-border insolvency was addressed in Article 5, stating:

“*Article 5:*

*Once the procedure for bankruptcy is initiated according to this Law, it shall come into effect in respect of the debtor’s property outside of the territory of the People’s Republic of China.*

*Where a legally effective judgment or ruling made in a bankruptcy case by a court of another country involves a debtor’s property within the territory of the People’s Republic of China and the said court applies with or requests the people’s court to recognise and enforce it, the people’s court shall, according to the relevant international treaties that China has concluded or acceded to or on the basis of the principle of reciprocity, conduct an examination thereof and, when believing that the said judgment or ruling does not violate the basic principles of the laws of the People’s Republic of China, does not jeopardize the sovereignty and security of the State or public interests, does not undermine the legitimate rights and interests of the creditors within the territory of the People’s Republic of China, decide to recognise and enforce the judgement or ruling.”*

## **4.4 Cross-Border Insolvency under the EBL 2006**

### **4.4.1 The Meaning of Article 5**

It has been acknowledged that Article 5 under EBL 2006 is a gap-filling law in

Chinese bankruptcy law history, and which addresses legal issues for both inbound and outbound bankruptcy cases.<sup>101</sup> The understanding of cross-border insolvency in Chinese legal society has been mainly influenced by advanced jurisdictions, and Chinese scholars have agreed that most multinational insolvency cases involve two main issues: the recognition and repayment of foreign creditors' claims; and the management of debtors' foreign assets. In general, the wording of Article 5 seems to pay more attention to the issue of foreign assets. The first paragraph deals with the extraterritorial effect of Chinese bankruptcy law over the foreign assets of the debtor under Chinese proceeding, and the second regulates the conditions that foreign proceedings need to satisfy in order to get control of foreign debtors' assets located within China's border.

As mentioned previously, the article has been discussed and re-drafted several times during the process of the reform of Chinese bankruptcy law, so the lawmakers have put enough political and legal considerations into the final form. Since the underlying policy of the law is to boost the Chinese market economy and encourage capital flow into China,<sup>102</sup> it is necessary to analyse the legal principles behind the language of Article 5 to see whether a single article could provide a certain and effective cross-border bankruptcy system.

Firstly, for any insolvency proceedings opened in Chinese courts, the law will be applied to all the debtor's assets, both within and outside of the territory of China. Since the law did not give a detailed procedure for managing foreign assets, following the logic of dealing with domestic cases, the article implies that, after the Chinese court accepts the bankruptcy application: all the insolvent assets should be put into the pool of assets for distribution based on Chinese law; individual actions against the debtors' assets shall be stopped; and other civil actions or arbitrations related to the debtor that have not been concluded should be discontinued until the administrator takes over the assets. Moreover, it also means that the repayment to individual creditors made by the debtor using foreign assets after acceptance in the Chinese court should

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<sup>101</sup> Haizheng Zhang and Ran Gao (n 92), 93.

<sup>102</sup> Article 1, EBL 2006.

be invalidated.<sup>103</sup> The demonstration of the Chinese bankruptcy law's extraterritorial effect reflects the basic concepts of universalism in regulating cross-border insolvency. The similar effect also can be found under the US Bankruptcy Code. The definition of bankruptcy estate includes all the assets within the US or abroad, wherever they may be located.<sup>104</sup> Although the realisation of such an effect usually involves recognition and assistance based on the law of the foreign jurisdictions related, it provides a legal basis for Chinese administrators seeking assistance and cooperation abroad.<sup>105</sup> However, unlike the US bankruptcy system which has adopted the UNCITRAL Model Law, which offers detailed procedures for seeking foreign cooperation, Chinese law is silent on this matter.

Following the spirit of universalism in the first part, the second paragraph of Article 5 states that foreign insolvency judgments can be recognised and enforced based on an examination conducted by Chinese courts. There are two types of examination implied by the language of Article 5, and a successful recognition requires the satisfaction of both.<sup>106</sup> The primary examination should be on the grounds of existing international treaties or the principle of reciprocity between China and the involved jurisdiction. Since China has not entered any international agreement or conventions on cross-border insolvency or judicial assistance, international treaties here mainly refer to bilateral treaties on judicial assistance in civil and commercial matters. Additionally, the principle of reciprocity has often been included in bilateral agreements in civil and commercial matters. Therefore, it means that if there is no such agreement, it would be very difficult for a foreign insolvency judgment to get recognition in China as Chinese courts usually apply passive attitudes toward the application of reciprocity. After it has been proved there is an international treaty or reciprocity between two countries, the examination

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<sup>103</sup> Article 16-19, EBL 2006, which mainly about the legal effects of the acceptance of insolvency cases.

<sup>104</sup> § 541 Property of the estate, U.S. Code Chapter 11 (the US).

<sup>105</sup> Charles D Booth (n 59) 310-312.

<sup>106</sup> Steven J. Arsenault, 'Leaping over the Great Wall: Examining Cross-Border Insolvency in China Under the Chinese Corporate Bankruptcy Law' (2011) 21 *Ind. Int'l & Comp. L. Rev.*, 2.

will be moved into the second stage. The courts need to make sure the recognition or enforcement of a foreign judgment would not violate the basic principles of Chinese law: sovereignty, public interests and the Chinese creditors' legal rights. This part has been criticised for being vague and imprecise because it allows for broad discretionary powers, despite the article having been redrafted several times to limit such powers.<sup>107</sup>

#### 4.4.2 Uncertainties in Practice

In practice, Article 5 did not receive a comprehensive analysis of its application until 2010. Because of the increasing amount of both inbound and outbound insolvency cases, Chinese legal society started to realise the huge gap between the Chinese law and international solutions in this area.<sup>108</sup> There are two cases which could illustrate the essential issues of Article 5. For inbound cases, *Taizinaï*<sup>109</sup> was the changing point since it was the first Chinese enterprise to receive a bankruptcy order from a foreign court. The dramatic development of the *Taizinaï* case was widely reported by the media, and caused much discussion about the application of Article 5 under the new EBL. For outbound cases, the reorganisation proceeding of *Zhejiang Topoint Photovoltaic Co. Ltd*<sup>110</sup> is a good example. Based on the UNCITRAL Model Law system, the Chinese proceeding got recognition under the US Bankruptcy Code for the first time.

#### ***Taizinaï***<sup>111</sup>

Taizinaï Group was a dairy company incorporated in Hunan Province. In 2006,

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<sup>107</sup> Qingxiu Bu, 'China's enterprise Bankruptcy Law (EBL 2006): Cross-Border Perspective' (2009) 18 *Int. Insolv, Rev.* 187.

<sup>108</sup> Haizheng Zhang and Ran Gao (n 92).

<sup>109</sup> The case was not officially reported. Information mainly come from professional journal articles and media reports.

<sup>110</sup> *In Re Zhejiang Topoint Photovoltaic Co, Ltd*, CASE NO. 14-24549 (GMB).

<sup>111</sup> Case facts sources: Guowen Zou, 'The legal Analysis and Consideration of the Taizinaï Bankruptcy Case' (2011) Hunan Normal University; Legal Weekly, "Taizinaï Could be the First Case of Cross-Border Insolvency in China (2010) <<http://finance.sina.com.cn/chanjing/sdbd/20100429/10037850220.shtml>> accessed 15 August 2017.

as part of a restructuring and development plan, three international investors, Morgan Stanley, Goldman Sachs and Actis Capital, agreed to pay 73 million USD for a 31.4% shareholding in the enterprise; additionally, for a better taxation policy, the company's ownership was transferred to a holding company registered in the Cayman Islands. To support the expansion plan, the company got another loan from Citigroup. However, in 2008, the company ran into financial difficulties under the influence of the global financial crisis, and the safety scandal in the Chinese dairy industry. Because the company could not meet its financial targets, based on the valuation adjustment mechanism agreed in 2006 between the company owner, Li Tuchun, and the three investors, Li transferred the ownership to those foreign investors. Since Taizinaï was one of the largest enterprises in Hunan province, the large number of unpaid employees forced the local government to intervene. Thus, the local government reached an agreement with the foreign investors, and invested almost 100 million RMB to repay some of the creditors. Li also got the ownership back.

Although the temporary problem was solved by the government, the company was still unable to repay its debt to Citigroup. Hence, Citigroup applied for liquidation in the Cayman Islands, and successfully obtained a liquidation order in 2010. The court also appointed a Hong Kong accounting firm as the provisional liquidator to deal with the insolvent assets in China. The management group of Taizinaï refused to accept the judgment of the Cayman Islands and claimed it had no legal effect in China. Under this difficult situation, the local government intervened again. The local court reached an agreement with the foreign liquidator which decided that the local court would start a reorganisation procedure. In 2011, the reorganisation administrator signed an agreement with two enterprises, including a major state-owned dairy enterprise, and they agreed to take over Taizinaï for reorganising and repay its debts.

The first noticeable issue of the case was that the local government had played a very important role in the rescue process. It is clear that the central or local government has a good tradition of intervention in bankruptcy

cases.<sup>112</sup> In the process of solving the case, the government invested significant capital to repay the foreign creditors, and also played the main role in negotiating with foreign creditors and the liquidator. The legal basis for government intervention, which is to protect the order of the socialist market economy, was outlined in the new bankruptcy law.<sup>113</sup> Therefore, it could have been predicted that government involvement would still play a significant role in both domestic and international bankruptcy cases under the EBL 2006.

Regarding the international elements of the case, there are two main issues relating to this research. Firstly, one of the main issues the Chinese legal scholars argued is whether the Cayman Islands has jurisdiction to open the insolvency proceeding against Taizina. The enterprise was an off-shore company registered in the Cayman Islands, and its management centre and all businesses were located in China. When creditors filed an insolvency application against the Cayman Islands holding company, the court naturally had jurisdiction. Furthermore, according to the law there, the insolvency court has the right to appoint a liquidator to deal with the insolvent debtors' assets, wherever they are located. Therefore, the liquidation order made by the Cayman Islands was legally correct. The second issue is whether the foreign judgment could be recognised under the new Chinese bankruptcy law.

Following the local government's interference, it was unclear whether the foreign liquidator had applied for recognition of the Cayman Islands judgment according to Article 5. However, if the liquidator had, the Chinese court would probably not have granted the recognition under Article 5. Based on the examination process mentioned above, there is no reciprocity relationship or bilateral agreement about judicial assistance between China and the UK or the Cayman Islands. Thus, the recognition would be rejected at the primary examination stage. Also, the enterprise had businesses in many different locations within China, and a large number of creditors and employees in different provinces. The Chinese court would also have refused the

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<sup>112</sup> Andrew Godwin, 'Corporate Rescue in Asia---Trends and Challenges' (2012) *Sydney Law Review* 163.

<sup>113</sup> Article 1, EBL 2006.

recognition based on the reason that the liquidation of such large-scale enterprise would be harmful to social stability and the interests of Chinese creditors.

***Zhejiang Topoint Photovoltaic Co. Ltd***<sup>114</sup>

The company was a large-scale enterprise engaged in the solar and photovoltaic energy industry, located in Haining, Zhejiang Province. In 2013, because of the industry's continuing poor performance influenced by the world economic environment, the company met financial problems and could not repay its debt (around £11 million) to a local Rural Credit Cooperative. Later that year, the government launched supportive policies to encourage the development of the solar energy industry. Therefore, because of the positive prospect of the industry and its better interests, the Credit Cooperative decided to file a reorganisation application against the debtor. AS the local court confirmed that the debtor met the conditions for bankruptcy, and thought that reorganisation would be in the best interests of the creditors, so the case was accepted. During the proceeding, the court noticed the debtor had substantial assets (around £15 million) in the US, which mainly comprised of solar panels in a warehouse located in New Jersey. On July 2014, the administrator appointed by the Chinese proceeding filed a petition to the bankruptcy court of New Jersey for recognition of the Chinese reorganisation proceeding as a foreign main proceeding. In August, the court granted the recognition since the Chinese proceeding met the conditions set by section 1517 of the US Bankruptcy Code for granting recognition. Additionally, according to Articles 1519 and 1521, all the individual actions against the debtor's assets within the US were stayed or suspended.

This case is significant in Chinese bankruptcy history because it was the first one recognised by the US Bankruptcy Court.<sup>115</sup> Since China and the US are

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<sup>114</sup> *In Re Zhejiang Topoint Photovoltaic Co, Ltd*, CASE NO. 14-24549(GMB); Junhe, 'The Practical Points of the Chinese Insolvency Proceeding Getting Recognition in the US' (2015) <[http://www.junhe.com/images/ourpublications/Research\\_Reports/Reports/Research\\_Reports\\_CN/20150204.pdf](http://www.junhe.com/images/ourpublications/Research_Reports/Reports/Research_Reports_CN/20150204.pdf)> accessed 12 September 2017.

<sup>115</sup> Zhejiang daily, 'Cross-Border Insolvency Vitalise Foreign Assets' (11 November

mutual trading partners, commercial disputes and bankruptcy cases between the two states have increased significantly in recent years. For Chinese enterprises, the case would be a legal precedent under the US law and offer help to future cases. However, for cases from the US, the possibility of recognising foreign judgments under Chinese law could be limited; and currently, there is no international or bilateral agreement regulating multinational insolvency that has been reached by both countries. Although China does not apply a case law system, the Topoint case would provide the possibility for a Chinese court applying the reciprocity principle to recognise the US bankruptcy proceedings. On the other hand, the case also showed Chinese legal practitioners the essential role the cross-border insolvency law played in multinational businesses, and the effectiveness of the international cooperation system. For the Zhejiang debtor, it took less than one month from filing the petition to receiving the recognition order. Such a system would undoubtedly provide valid and timely protection for Chinese debtors' foreign assets. Consequently, the case forced Chinese lawmakers and practitioners to review the current system and look for detailed guidance.<sup>116</sup>

According to the analysis of the two cases, it could be said that the cross-border insolvency law in China is far from clear. Chinese professionals have also realised that mutual respect and cooperation could be the best way to solve these complicated questions.<sup>117</sup> Since Chinese courts did not have enough experience dealing with international insolvency matters, the application of Article 5 would be impractical without detailed interpretations and procedures. From the legal perspective, the current law has set limited and strict conditions for granting recognition of foreign judgments. In an environment of commercial globalisation, when foreign creditors' interests could not be fully protected, this would hurt the reputation of the Chinese market in the eyes of international investors.<sup>118</sup> Furthermore, foreign courts

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2014) <[http://zjrb.zjol.com.cn/html/2014-11/11/content\\_2822169.htm?div=-1](http://zjrb.zjol.com.cn/html/2014-11/11/content_2822169.htm?div=-1)> accessed 12 September 2017.

<sup>116</sup> Junhe (n 114).

<sup>117</sup> *ibid.*

<sup>118</sup> Chuyi Wei (n 42), 316.

may refuse to assist Chinese proceedings as retaliation. It is obvious that the Chinese courts do not want to see situations in which Chinese creditors' legal rights cannot be protected in foreign proceedings, or justified judgments made by Chinese courts cannot get assistance in foreign courts. It also should be realised that government intervention cannot always be the solution to international insolvency cases. Even if it could be justified to protect local employment and creditors, influencing the market self-adjustment process would probably increase the economic burdens of the government, and eventually hurt the market order. From the economic point of view, it requires a friendly international insolvency law to attract more foreign investment. Also, Chinese enterprises have tended to expand their businesses onto the international stage in recent years, and the Chinese government has also been encouraging them to do so. Since China has the ability and desire to play a more important role in the international market, the state should also bear the responsibility of building an effective and fair insolvency system for solving international business problems.

#### **4.5 Comparative Analysis of the UNCITRAL Model Law**

The UNCITRAL Model Law on Cross-Border Insolvency is one of the main international regimes, and Chinese insolvency professionals have realised the advantages of the system. The comparison in this part aims to analyse the essential differences between the Chinese legal system and the Model Law regime in solving international insolvency issues. Two points need to be stressed about the two objects. Firstly, since the UNCITRAL Model Law is a legal instrument to be adopted by individual jurisdictions, the comparison involves other countries' insolvency law systems and their implementation of the Model Law as examples and explanations about the Model law's intentions. Secondly, because there is only one article under Chinese law regulating cross-border insolvency, other Chinese laws, such as Company Law and Civil Procedural Law, will be involved to explain the legal principles and intentions behind the simple article, and to examine the cross-border insolvency law

under the overall Chinese legal system.

#### **4.5.1 Universalism or Territorialism?**

As analysed in Chapter 2, universalism and territorialism are the two distinct principles that reflect basic attitudes toward cross-border insolvency. The UNCITRAL Model Law has adopted universalism, providing that only one main insolvency proceeding will play the main role and manage the overall process. On this basis, the law modified the principle by allowing territorial proceedings. Such modification aims to encourage cooperation and coordination; also, it shows respect to the differences among national insolvency laws, and gives national courts opportunities to protect local interests when needed.<sup>119</sup> Although universalism is the growing trend in solving international issues, territorialism is still the historical philosophy.<sup>120</sup> Some evidence illustrates that China is moving away from a strict territorial method to some extent through Article 5, under which the international effects of Chinese proceedings are claimed, and the cooperation and assistance with a foreign proceeding may be possible. However, those conditions for recognition could be very restrictive and uncertain, since the vague language would give Chinese courts greater discretionary powers in deciding whether the foreign judgment is a breach of national interests or creditor's rights. Potentially, it leaves room for local protectionism.

Therefore, both Chinese law and the Model Law adopted universalism with some adjustments. While the Model law is aiming to encourage cooperation, the Chinese law possibly conducts double standards for inbound and outbound cases; Arsenault described the law as being modified universalism in character.<sup>121</sup> It has been disclosed that during the drafting stage, the

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<sup>119</sup> Purpose of the Model Law, UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, 19.

<sup>120</sup> LM LoPucki, 'Cooperation in International Bankruptcy: A Post-Universalist Approach' (1999) 84 *Cornell L. Rev.* 696.

<sup>121</sup> Steven J Arsenault, 'Leaping Over the Great Wall: Examining Cross-Border Insolvency in China under the Chinese Corporate Bankruptcy Law' (2011) 21(1) *Indiana International & Comparative Law Review* 2.

Chinese team agreed with the UNCITRAL advisors that universalism would be adopted into the new law.<sup>122</sup> Frankly speaking, the principle which Article 5 adopted is universalism with features of territorialism.

#### **4.5.2 Jurisdiction**

As analysed in Chapter 2, one of the three main issues of cross-border insolvency is to decide which country's court has the jurisdiction to open the insolvency proceeding. The national insolvency laws were designed based on the individual state's legal philosophy and principles to protect national interests and local creditors in international disputes, so there are different standards in deciding jurisdictions of cross-border insolvency; furthermore, conflicts can be caused when involved countries are competing to claim jurisdiction. Domiciliary insolvency is the basic standard many countries have applied in regulating jurisdiction issues of international insolvency.

The principle has been adopted by both the Model Law and Chinese law. Under the Model law, the starting point of Article 16 is the debtor's registered office, which is presumed to be the centre of the debtor's main interest, and the proceeding opened in the country of the COMI should be recognised as the foreign main proceeding. In addition, the presumption can be rebutted if there is clear evidence showing the debtor's COMI and registered office are different.<sup>123</sup> On this basis, secondary proceedings are also allowed for the purpose of assisting the main proceeding, and the jurisdiction of non-main proceedings is limited to local assets. Chinese law also applied the domiciliary standard, which regulated that the People's courts at the place where the debtor resides shall have the jurisdiction to open insolvency proceedings under the EBL 2006.<sup>124</sup> The General Principles of the Civil Law pointed out that the debtor's residence means the location of the debtor's major business operation, and the Supreme Court offered further explanation, stating that if

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<sup>122</sup> Weiguo Wang, 'National Report for the People's Republic of China', in Dennis Faber et al. (eds.), *Commencement of Insolvency Proceedings* (Oxford 2012) 172-173.

<sup>123</sup> Article 16 (3), the UNCITRAL Model Law on Cross-border Insolvency.

<sup>124</sup> Article 3, EBL 2006.

there was no clear location of the major business operation, the courts in the place of registration have jurisdiction.<sup>125</sup> Therefore, although Chinese laws did not apply the concept of centre of main interest (COMI), the basic ideas of Chinese jurisdiction rules for insolvency cases are similar to those of the Model Law. Both of the systems applied the system that place of registration has presumed jurisdiction, and it can be challenged if obvious evidence proves the location of the place of registration, and management of the business or centre of operations is different. It is necessary to use the registration location as a start point for insolvency proceeding because such a location is predictable and accessible to all creditors. However, in the situation that a company is registered in one place and its business operation is located in different place, which is very common in commercial practice and multinational business activities, it is more reasonable for the court where the major business activities and management are conducted to have the jurisdiction. The problem here is that there is no clear definition of the meaning of “major business operation” under the Chinese Supreme Court’s interpretation.

However, unlike the Model Law which limits the jurisdictions in secondary proceedings to a debtor’s local assets, Chinese laws offer the courts broad powers to apply jurisdiction over companies that do not have a residence in China. According to Article 265 of the Civil Procedural Law, Chinese courts can apply jurisdiction over a foreign company if the company has assets or a representative body in China.<sup>126</sup> Such broad jurisdiction rules for cases with international elements are not uncommon under national insolvency laws; countries like the US and the UK have similar rules. The purpose is to give better protection to local creditors when it is necessary since they do not need to learn foreign insolvency laws and file the case in a debtor’s home country.<sup>127</sup>

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<sup>125</sup> Article 39, The General Principles of the Civil Law (China); Article 1, Provisions on Some Issues Concerning the Trial of Enterprise Bankruptcy Cases, interpretation No 23 [2002] by the Supreme People's Court.

<sup>126</sup> Article 265, The Civil Procedural Law of PRC.

<sup>127</sup> Wantao Yang and Sheng Chen, ‘The Theories and Practice of Chinese Cross-Border Insolvency’ (2012) 3 *Financial Service Law Review* 338.

It should be noticed that such protection reflects the territorial philosophy and, for cross-border insolvency, abusing such protection could be an obstacle to achieving a better result to satisfy creditors' claims as a whole.

The early cross-border insolvency case decided by Shenzhen SEZ is a good example, which shows that the territorial solution gave local creditors quick repayment, but lowered the recovery rate. In *The Bank of Credit and Commerce International (BCCI) case*,<sup>128</sup> BCCI was a banking group with numerous subsidiaries and branches all over the world, and was declared bankrupt in more than 70 jurisdictions in the early 1990s. Since BCCI has a branch in Shenzhen, the Intermediate Court claimed the jurisdiction on the grounds that certain amounts of debtor's assets were located in Shenzhen. The Chinese court accepted the case and started liquidation proceedings; accordingly, Chinese creditors only participated in the Chinese proceeding and did not join the global liquidation of the banking group. The Chinese court found that the branch's assets in China amounted to US\$ 20 million, but against almost US\$ 80 million in liabilities.<sup>129</sup> Based on the Chinese law, the local assets were distributed among Chinese creditors, and the rate of return allegedly was around 25%.<sup>130</sup> On the other hand, on the global level, provisional liquidators in different jurisdictions, including Luxembourg, the Cayman Islands, London, New York and Washington, successfully agreed to a Pooling Agreement whereby the liquidation of the BCCI Group would be undertaken together by a team of liquidators.<sup>131</sup> Although relevant cases have lasted for decades, the repayment rate is much higher than 25%.<sup>132</sup> There

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<sup>128</sup> Jingxia Shi (n 85), 39; Leslie A. Burton, 'Toward an International Bankruptcy Policy in Europe: Four Decades in Search of a Treaty' (1999) 5 *Ann. Surv. Int'l & Comp. L* 227.

<sup>129</sup> *ibid.*

<sup>130</sup> Yitao Yang and Sheng Chen, 'The Theories and Practice of Cross-Border Insolvency in China' (2012) 3 *Financial Service Law Review* 338.

<sup>131</sup> Ian F. Fletcher, 'International Insolvency: A Case for Study and Treatment' (1993) 27 (2) *The International Lawyer* 429, 434-436.

<sup>132</sup> Deloitte, 'BCCI bank fraud begets silver lining 13 years later', which reported that liquidators have recovered about 75% of creditors' lost money in 2013. <[https://web.archive.org/web/20071120081018/http://www.deloitte.com/dtt/case\\_study/0%2C1005%2Ccid%3D60139%2C00.html](https://web.archive.org/web/20071120081018/http://www.deloitte.com/dtt/case_study/0%2C1005%2Ccid%3D60139%2C00.html)> accessed 10 January 2018.

are two possible reasons why Chinese creditors chose not to participate in the global agreement. Firstly, both Chinese creditors and legal practitioners had relatively limited experiences in dealing with insolvency matters at that time; secondly, compared to the international agreement, the Chinese proceeding provided a much quicker result with a certain repayment rate, and it is true that the global liquidation required decades to complete.

In Professor Shi's word, 'the case could serve as a typical exemplification on China's adherence to the territoriality principle in dealing with cross-border insolvency cases.'<sup>133</sup> In terms of the modern trend of commercial globalisation, the case proves that participating in international proceeding could have a better result for creditors in a multinational insolvency. However, it seems that Chinese laws give courts excessive jurisdiction powers over foreign companies that have a connection with China. Furthermore, Chinese laws show a negative attitude toward parallel proceedings, since the Supreme Court stated that if there are foreign proceedings opened against the same debtor under the Chinese proceeding, the foreign proceedings and judgments shall not be recognised in China unless there are bilateral agreements between China and the foreign country in question.<sup>134</sup> Since flexible jurisdiction is necessary at the national level to protect domestic creditors, the Model Law approach provides a good solution to deal with the relationship among various proceedings against the same debtor.

By introducing the concept of COMI, it confirms the jurisdiction of the debtor's home country, and puts limitations on the jurisdiction of ancillary proceedings. Allowing the local proceedings not only shows respect to the local jurisdiction rules but also give domestic creditors the opportunity to learn comprehensive information of the debtor's case in other countries, which would help them cooperate with and participate in the main proceeding. It has been discussed how the Model law approach illustrates the spirit of international cooperation;

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<sup>133</sup> Jingxia Shi (n 85), 40.

<sup>134</sup> Article 306, Opinions on Some Issues Concerning the Application of the Civil Procedure Law of the People's Republic of China, the Supreme People's Court [1992] Judicial Interpretation No. 22.

the EC regulation on cross-border insolvency also adopts a similar system.<sup>135</sup> The potential problem of the Model Law approach is that enacting countries may have different rules about the domestic proceedings since the Model Law is not mandatory law. Some countries may take the opportunity to make sure secured local creditors get paid before submitting the assets to a foreign representative, which would possibly cause some unfair issues in some cases.

In fact, although Article 5 of EBL 2006 states that all the insolvency proceedings opened in Chinese court have jurisdiction over the debtors' assets all over the world, the recognition of Chinese proceeding in foreign courts will depend on the national law of the foreign country in question. If the Chinese court applies jurisdiction over foreign companies on the ground of the presence of assets in China, such proceedings will only be recognised as foreign non-main proceeding in enacting countries of the Model Law, and its effects are only restricted within China. Therefore, the jurisdiction rules for cross-border insolvency in China could be chaotic and conflict with the trend of international cooperation since there are no detailed rules in the new insolvency law, and other related laws are still conducting rules with territorial protection purposes.

#### **4.5.3 Choice of law**

The choice-of-law rules related to cross-border insolvency include problems of both substantive and procedural issues.<sup>136</sup> From the opinions on territorialism, some countries and scholars think that applying the law of the jurisdiction where the insolvency proceeding was opened should be the best solution, since the single law proceeding would be more convenient and effective; it would also be good for the protection of local creditors.<sup>137</sup>

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<sup>135</sup> Article 3 (1), Regulation (EU) 2015/848 of European Parliament and of the Council on Insolvency Proceeding (Recast).

<sup>136</sup> Hannah L. Buxbaum, 'Rethinking International Insolvency: The Neglected Role of Choice-of-Law Rules and Theory' (2000) Articles by Maurer Faculty. Paper 395. < <https://www.repository.law.indiana.edu/cgi/viewcontent.cgi?article=1396&context=facpub> > accessed 10 September 2017.

<sup>137</sup> Zuofa Wang, 'The Legal Conflicts and Choice-of-Law under Cross-Border Insolvency' (2005) 6 *US-China Law Review* 69.

However, the problem is much more complicated in the case of universalism. In general, for procedural issues such as jurisdiction, the requirements of submitting insolvency application, the process of appointing qualified administrators, or the rules of submitting creditors' claims, the applicable law should be the national law in which insolvency proceedings are started, which expresses the judicial sovereignty of individual countries and avoids conflicts.<sup>138</sup> For substantial problems, since it is directly related to the legal rights and contractual relationships between creditors and debtor which were formed before the commencement of insolvency, where proceedings are based on other applicable laws, such as civil and commercial laws, it is reasonable that those applicable laws should still be used to determine the relative position of each of those rights and relationships.<sup>139</sup>

Under the Model Law system, there are no unified choice-of-law rules for countries to adopt: countries need to decide the issue based on their private international law. But the UNCITRAL Legislative Guide on Insolvency Law provides some recommendations on this matter concerning the characteristics of universalism. The UNCITRAL stresses that the issue of validity and effectiveness of rights and claims against the debtor is not an insolvency problem, but a matter of other applicable laws.<sup>140</sup> The recommendations state that:

“30. The law applicable to the validity and effectiveness of rights and claims existing at the time of the commencement of insolvency proceedings should be determined by the private international law rules of the State in which insolvency proceedings are commenced.

31. The insolvency law of the State in which insolvency proceedings are

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<sup>138</sup> Charles W. Mooney Jr, 'Harmonising Choice-of-Law Rules for International Insolvency Cases: Virtual Territoriality, Virtual Universalism, and the Problem of Local Interests' (2014) University of Pennsylvania Law School, Faculty Scholarship Paper 1418.

<sup>139</sup> Zuofa Wang (n 137).

<sup>140</sup> Applicable Law in Insolvency Proceeding, UNCITRAL Legislative Guide on Insolvency Law, 67 <[http://www.uncitral.org/pdf/english/texts/insolven/05-80722\\_Ebook.pdf](http://www.uncitral.org/pdf/english/texts/insolven/05-80722_Ebook.pdf) > accessed 10 May 2017.

commenced (*lex fori concursus*) should apply to all aspects of the commencement, conduct, administration, and conclusion of those insolvency proceedings and their effects.”<sup>141</sup>

Additionally, there are further recommendations that include a list of 19 detailed examples of procedural issues, and certain exceptions in respect to recommendation 31.

Although the UNCITRAL did not give a specific choice-of-law rule, it does not mean that the problem was ignored by the Working Group. In fact, the problem was left open on purpose by UNCITRAL in order to achieve a balance between countries’ preferences and international cooperation.<sup>142</sup> When deciding the effects of the foreign law in the recognising country, the Model Law specifically rejects the approach that the recognising court only applies the local law or the foreign law where the insolvency proceeding was opened.<sup>143</sup> Instead, the law finds the middle ground, which specifies that the effects should be automatically applied upon recognition. Furthermore, the law also requires that those effects only apply to the foreign main proceeding, and subject to the law of recognising countries.<sup>144</sup> By using these automatic stays, the recognising court does not need to decide the applicable law, and could also protect debtor’s assets quickly. For both foreign main and non-main proceedings, the recognising courts have great discretionary powers to make any appropriate replies based on their conflict of laws rules.<sup>145</sup> Therefore, combining the Legislative Guide and the Model Law, it seems that UNCITRAL intends to encourage the recognising courts to make a comprehensive assessment of the situation following the recommendations listed above when facing choice-of-law issues.

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<sup>141</sup> *ibid*, Recommendation 30-34, 72.

<sup>142</sup> UNCITRAL, Working Group on Insolvency Law, Rep. on its 18th Sess., Oct. 30–Nov. 10, 1995, para 55-56 (Dec. 1, 1995).

<sup>143</sup> Look Chan Ho, ‘Applying Foreign Law---Realising the Model Law’s Potential’ (2010) *Journal of International Banking Law and Regulation* 552.

<sup>144</sup> Article 20, the UNCITRAL Model Law.

<sup>145</sup> Article 21, the UNCITRAL Model Law.

Under the Chinese legal system, the limited language about choice-of-law issues seems to comply with the recommendations promoted by UNCITRAL, but the practical application illustrates a very different situation. There are no clear choice-of-law rules regarding situations with international elements under EBL 2006. However, the law states that if there are no provisions in this law to govern the process of bankruptcy cases, the relevant provisions of Civil Procedural Law shall be applicable.<sup>146</sup> Accordingly, the Civil Procedural Law implies that civil proceedings opened within Chinese territory shall be governed by relevant provisions of this law.<sup>147</sup> This article reflects the Chinese law attitude, that procedural issues should be governed by law where the insolvency proceeding is opened.

For substantial matters, another law, called Law of the Application of Law for Foreign-Related Civil Relationships of PRC, includes one article about the choice-of-law rule of contract.<sup>148</sup> It provides that the parties concerned may choose the applicable law by agreement to govern the contract; if parties do not choose, the law at the habitual residence of the party whose fulfilment of obligations can best reflect the characteristics of the contract, or other laws which have the closest connection with the contract, should apply. In practice, it could be difficult to have unified standards for deciding location that can reflect the contract's characteristics or have a close connection with the contract in question; therefore, such law gives the judge a great level of discretionary power to make a comprehensive judgment.<sup>149</sup> Several legal scholars have pointed out that Article 41 has a supplementary nature since it guides courts to decide applicable law when there is no clear statement about the issue under contract.<sup>150</sup>

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<sup>146</sup> Article 4, EBL 2006.

<sup>147</sup> Article 4, Civil Procedure Law 1991 (revised 2017).

<sup>148</sup> Article 41, Law of the Application of Law for Foreign-Related Civil Relationships of PRC 2010.

<sup>149</sup> Zhumei Ye, 'The legal Position of "close connection" under Law of Applicable Law in Foreign-Related Civil Matters' (2014) 3 *Journal of Gansu Political Science and Law Institute* 108.

<sup>150</sup> Yue Lu, 'Judicial Application of the Closest Connection Doctrine of Law in the Application of Law for Foreign-Related Civil Relations' (2015) 13 (4) *Present Day Law*

However, when Chinese courts apply this law in practice, the choice of law issues are always decided based on the jurisdiction decisions. It means that if there is no choice-of-law agreement in the contract and the Chinese court applies jurisdiction because the performance of the contract was in China, the court would have a good chance of deciding that the Chinese law has a close connection with the contract, and thus apply Chinese law.<sup>151</sup> One piece of empirical research demonstrates that Chinese law was the applicable law for all the sample cases decided based on Article 41.<sup>152</sup> Using such a close connection rule as a unilateral rule is not the intention of that rule since it is supposed to increase the flexibility and accuracy in deciding choice-of-law for international disputes. This article could be an example to show that Chinese laws or courts have not paid much attention to choice-of-law rules in international cases, and the application of domestic laws is still the mainstream in Chinese courts. Therefore, it is reasonable to believe that Chinese courts prefer to apply local laws to both procedural and substantial laws in international cases.

Additionally, the Model Law of International Private Law of the PRC, which is published by the Chinese Society of Private International Law and serves as recommendations and reference for courts and legal professionals, has mentioned the choice-of-law rules of insolvency situations for the first time.<sup>153</sup> The law states that the applicable law should be the law where the debtors' business operation centre or debtors' assets are located.<sup>154</sup> The law further explains that if the debtor or creditor apply for insolvency in the court where the main business operation centre is located, the applicable law should be the law where the court is located; if the creditor applies for insolvency in the

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*Science* 105.

<sup>151</sup> *ibid*, 109-110.

<sup>152</sup> *ibid*.

<sup>153</sup> Chinese Society of Private International Law, *The Model Law of International Private Law of People's Republic of China* (Law Press 2000). The society of private international law drafted by Chinese leading international private law scholars, which embodies the latest and highest level of research in China in the field of private international law.

<sup>154</sup> Article 148, the Model Law of International Private Law of PRC.

court where the assets are located, the applicable law should be the law where the court is located. So the logic is to connect the applicable law with the commencement location of the proceeding. This law is more advanced and complies with the concept of modified universalism for international insolvency.

According to the law, the proceeding opened in the court where the business operation centre is located would apply the local law of that jurisdiction. It has been addressed previously how the concept of the business operation centre under Chinese law shares common principles with the COMI under the Model Law so that such a proceeding would be recognised as the main proceeding under the Model Law system. In other words, the concept of the business centre would be used to decide both the jurisdiction and the applicable law. Internationally, this approach has been supported by universalists. Jay Lawrence Westbrook pointed out that international rules for regulating multinational insolvency cases concentrate on the COMI, and to achieve the goal of universalism, it is necessary to use the concept for both choice-of-forum and choice-of-law rules.<sup>155</sup> Hence, although the provisions of Chinese academic law does not address the concept of the COMI, the principles reflect the international trend. It shows that Chinese legal scholars have realised the importance of choice-of-law rules in multinational insolvency cases. In fact, the academic law was one of the main sources for the draft of the Law of the Application of Law for Foreign-Related Civil Relationships, but the final version excluded many specific issues, including articles concerning insolvency issues.

In summary, neither the Model Law system nor the Chinese law has unified choice-of-law rules for multinational insolvency cases; however, there are essential differences between the two systems. For Chinese laws, there are only limited provisions under different laws which are related to choice-of-law rules. When applying those rules to cases with international elements, the Chinese courts tend to make decisions based on jurisdiction and usually fail to make a comprehensive judgment by assessing the whole situation. As a

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<sup>155</sup> Jay Lawrence Westbrook, 'Universalism and Choice of Law' (2005) 23 *Penn St. Int'l L. Rev.* 625.

result, Chinese laws would be the applicable laws for most international cases heard in China. On the contrary, the Model Law adopts the middle ground for the issue on purpose. Instead of making separate rules, the Model Law intends to connect the choice-of-law rule with the COMI. As Jenny Clift stated: “(COMI) as a choice of principal forum, it has important implications for the choice of insolvency law applied to main proceedings and the substantive outcomes for stakeholders.”<sup>156</sup> Those automatic stays, triggered by recognition of the main proceeding, would protect a debtor’s assets and also provide flexibility for recognising courts to deal with cases based on practical considerations and circumstances of the particular case.<sup>157</sup> Following the recognition, discretionary reliefs are allowed to be granted to both main and non-main proceedings based on the local choice-of-law rules. Therefore, it is clear that every step in applying the Model Law is connected with the determination of the debtor’s COMI. With the encouragement of international cooperation and coordination, the law is a framework for regulating cross-border insolvency based on the choice of forum rule, and it is reasonable to believe such a system encourages a certain degree of deference to the foreign law of the main proceeding.<sup>158</sup>

However, without written provisions under the Model Law, the disadvantage is that enacting jurisdictions may adopt different interpretations and approaches to solving a single issue. For instance, as discussed in Chapter 3, the courts of the US and the UK have a contrary attitude towards granting discretionary relief by applying foreign law. With the condition that the foreign proceeding has been recognised as the main proceeding, the UK law thinks the relief should be restricted to relief that would be available to domestic proceedings, and foreign law should not be applied.<sup>159</sup> US law believes that refusing the possibility of using the law of foreign main proceeding would protect and

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<sup>156</sup> Jenny Clift, ‘Choice of Law and the UNCITRAL Harmonisation Process’ (2014) 9 (1) *Brooklyn Journal of Corporate, Financial & Commercial Law* 20, 29.

<sup>157</sup> *ibid*, 28-30.

<sup>158</sup> *ibid*. 26-27.

<sup>159</sup> *Fibria Celulose S/A v Pan Ocean* [2014] EWHC 2124.

encourage forum shopping, which is not the intention of the Model Law.<sup>160</sup> To harmonise transnational insolvency proceedings, the US approach seems more consistent with the Model Law.

#### **4.5.4 Recognition and Cooperation**

One of the essential objectives of the Model Law is to provide a simplified procedure for recognition of qualifying foreign proceedings that would avoid time-consuming processes and improve the certainty of recognition. Following the aim, the recognition procedure under Model Law is simple and clear: it provides that if the foreign proceeding satisfies the requirement concerning the nature of foreign proceeding, and the evidence required by Article 15 has been submitted by a foreign representative appointed by a foreign court, the foreign proceeding shall be recognised as either a main proceeding or non-main proceeding.<sup>161</sup> The recognition can be refused if such recognition would be manifestly contrary to the public policy of the recognising jurisdiction.<sup>162</sup>

Article 5 under Chinese EBL 2006 also states the possibility of recognising foreign insolvency proceedings based on the bilateral agreements and rule of reciprocity. The article complies with the basic attitudes of Chinese courts towards foreign-related civil cases under the Civil Procedure Law. A foreign judgment needs to meet three requirements for recognition in Chinese courts. The first one is that the foreign judgment should be a judgment with legal effect, and the second is there is a bilateral agreement or reciprocity relationship between China and the jurisdiction in question regarding judicial assistance.<sup>163</sup> The last requirement is that the foreign judgment shall not be recognised if it violates the basic principles of Chinese laws or sovereignty, safety, and public interests.<sup>164</sup> Furthermore, based on the Supreme Court's opinions, the recognition should be granted by Chinese intermediate courts

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<sup>160</sup> *Re Condor Insurance Limited Co Ltd* 601 F 3d 319 (Fifth Circuit 2010).

<sup>161</sup> UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation.

<sup>162</sup> Article 6, The UNCITRAL Model Law.

<sup>163</sup> Article 276, Civil Procedure Law 1991 (revised 2017).

<sup>164</sup> *ibid.*

that have jurisdiction over the dispute; if there is no agreement or reciprocity rule in existence, the party concerned may file a separate lawsuit in the competent intermediate courts.<sup>165</sup> For cross-border insolvency cases, it means that the foreign representative has to file a separate application based on the Chinese civil law for judicial assistance if the recognition cannot be granted based on EBL 2006.

Therefore, it could be argued that the basic attitudes of Chinese courts for recognising and assisting foreign proceedings share some similarities with the Model Law system. Firstly, the recognition could be granted if the foreign proceeding fits the requirements under the laws. Secondly, the recognition will be rejected if it does not comply with the public policies or laws of the recognising country. However, the detailed requirements of the two systems are very different. While the Model Law is trying to simplify the process, the Chinese civil procedures and Article 5 of the EBL impose some obstacles in respect of international cooperation. Since there are fewer than 30 countries who have made judicial assistance agreements with China, the international insolvency cases from other jurisdictions need to open separate cases in China. In that case, it seems the introduction of Article 5 has no practical significance since the solution still goes back to the same approach as under Civil Procedures Law. Another result would be that foreign creditors may choose to directly file insolvency cases in China in order to avoid the complicated recognition process with foreign judgment, which would be time-consuming and inefficient for creditors as a whole. Additionally, it should be noticed that the list of jurisdictions that have already signed agreements with China does not include China's major trading partners such as the US, the UK, and Germany. Since it is highly possible a great number of multinational insolvency cases would involve jurisdictions that have frequent business activities with China, the current laws obviously cannot provide efficient solutions.

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<sup>165</sup> Article 318, Opinions on Some Issues Concerning the Application of the Civil Procedure Law of the People's Republic of China, the Supreme People's Court [1992] Judicial Interpretation No. 22.

**Table 2: The List of Countries Having Signed Judicial Assistance Agreement in Civil and Commercial Matters with China**

1. France	7. Morocco	13. Mongolia	19. Belarus	25. Tajikistan
2. Italy	8. North Korea	14. Romania	20. Kazakhstan	26. Uzbekistan
3. Spain	9. Tunisia	15. Russia	21. Egypt	27. Vietnam
4. Bulgaria	10. South Korea	16. Turkey	22. Greece	28. Lithuania
5. Thailand	11. UAE	17. Ukraine	23. Cyprus	29. Lao
6. Hungary	12. Poland	18. Cuba	24. Kyrgyzstan	

(Source: Ministry of Justice P.R.C)<sup>166</sup>

***Public Policy***

The notion of public policy is included in both the Model Law and the China EBL 2006. As the UNCITRAL mentioned that the notion is grounded in national law, the meaning may differ from state to state. Although there is no uniform definition of public policy, it has been addressed that, for the purpose of international cooperation, the understanding of public policy under the Model Law is more restricted than domestic public policy.<sup>167</sup> In practice, although there were some changes of wording when only a few countries adopted the Model Law, most of the enacting countries have narrowly interpreted the rule of public policy on a consistent basis with a UNCITRAL guide.<sup>168</sup> For instance, the decisions from the US suggest the fact that the application of foreign law causes a different result than US law is insufficient

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<sup>166</sup> Singapore signed the agreement too, however, it does not include acknowledgment of judgment.

<sup>167</sup> UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, 102-103.

<sup>168</sup> Michael A. Garza, 'When is Cross-Border Insolvency Recognition Manifestly Contrary to Public Policy' (2015) 38 (5) *Fordham International Law Journal* 1604.

to invoke article 1516 protection under the Model Law system.<sup>169</sup> Further explanations provide two factors which may trigger the protection. The first is if the foreign proceeding was procedurally unfair, and the second is if the application of foreign law or recognition of foreign proceeding would severely impinge the value of a US statutory or constitutional right, or granting the relief would hinder the ability of a US bankruptcy court to implement fundamental policies.<sup>170</sup>

Under Chinese laws, although the concept has been applied in both civil and commercial laws, neither the Supreme Court nor the legislature has provided an interpretation of the meaning of public policy. The EBL 2006 states that foreign judgment must not contradict “the basic principles of Chinese law “or violate “China’s state sovereignty, security or public social interests”.<sup>171</sup> The same language is also used in other Civil Procedure Law in provisions relating to assisting foreign cases.<sup>172</sup> Other laws, such as Contract Law and Private International Law, employed the wording “do not contradict China’s social public interests”.<sup>173</sup> All these terms mentioned above are treated as public policy principles in China. In an old Supreme Court case from the 1950s, the court pointed out that when deciding the issue of the recognition of foreign judgments, the recognising court shall examine whether the judgment is contrary to China’s substantive and procedural laws.<sup>174</sup> Generally, the characteristics of the concept of public policy are its vagueness and uncertainty, which offers flexibility to courts in its application. The courts have the discretionary power to refuse foreign judgment or the application of foreign law, which leaves room for the abuse of power. Therefore, it is necessary to limit the scope of the notion; otherwise, the basis of the conflict of laws system

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<sup>169</sup> *ibid.*

<sup>170</sup> *ibid*; *Qimonda AG Bankr. Litig.*, 433 B.R. 547,567 (E.D Va. 2010).

<sup>171</sup> Article 5, EBL 2006.

<sup>172</sup> Article 266, Civil Procedural Law of PRC.

<sup>173</sup> Article 5, Law of the Application of Law for Foreign-related Civil Relations of PRC 2010.

<sup>174</sup> Hu Zhenjie, ‘Recognition and Enforcement of Foreign Judgments in China: Rules, Interpretation and Practice’ (1999) 46 *Netherlands International Law Review* 291.

would be frustrated.

Specifically, it has been pointed out that although the spirit and function of public policy are similar under the private international law and domestic civil law, the application should be narrower and more limited for legal matters involving international elements. Chinese courts should treat the foreign law with respect, and only invoke an exception when the application of foreign law or foreign judgment would violate some legal, moral, social or economic principles so fundamental to China. The academic suggestion is consistent with the explanation of UNCITRAL, which states that broadly defining public policy would hamper international cooperation. Notably, the attitude was adopted in the Model Law of Private International Law of China, and the article about public policy employed the word “manifestly incompatible with the public policy of China”.<sup>175</sup> The term “manifestly” was introduced by Chinese scholars in order to comply with international custom, as UNCITRAL explains that the term is commonly used under international legal texts to emphasise the restricted application of public policy exception.<sup>176</sup>

### ***The principle of Reciprocity in China***

Under the EBL 2006, reciprocity is one of the requirements for the recognition of and assistance for foreign insolvency proceedings. The language of Article 5 for determining the enforceability of foreign judgments can also be found under Civil Procedural Law, which provides that in the absence of a treaty obligation, Chinese courts may consider the principle of reciprocity.<sup>177</sup> However, both the EBL and CPL did not offer a detailed explanation of reciprocity. The basic principle of the CPL states that if a foreign country imposes restrictions on the civil litigation rights of a Chinese citizen, enterprise or organisation, the Chinese courts shall adopt the principle of reciprocity regarding those rights of the citizen, enterprise or organisation of that foreign

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<sup>175</sup> Article 14, the Model Law of Private International Law of PRC.

<sup>176</sup> UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, 52.

<sup>177</sup> Article 281-282, the Civil Procedural Law of PRC.

country.<sup>178</sup> Thus, under the Chinese legal system, reciprocity is used as a method of retaliation that punishes the attitude of the foreign states for not honouring Chinese judgments.<sup>179</sup> The laws give Chinese courts the discretionary power to decide whether there is a reciprocity relationship with the foreign country. In judicial practice, China has one of the most restrictive reciprocity systems. In determining the existence of reciprocity, Chinese courts do not seem to give importance to the actual recognition practice of the foreign court in question; all that matters is the proof of the existence of judicial precedents according to which Chinese judgments were given effect.<sup>180</sup> This restrictive interpretation has made the recognition of foreign judgments in China almost impossible. In the past decades, the principle of reciprocity has been the most frequently applied instrument in refusing to recognise foreign judgments.<sup>181</sup>

In fact, the instances of successful applications for recognition of foreign judgments in China are still rare. Although there are few successful ones, such as *B&T* case mentioned in this chapter, the principle of reciprocity never played any striking role in those decisions.<sup>182</sup> The *Gomi Akira* case would be a good example to show the attitude of Chinese courts on this matter since the intermediate court case was instructed by the Supreme People's Court.<sup>183</sup> In this case, the Japanese applicant applied to the Chinese court for recognition and enforcement of Japanese judgments ordering a Japanese

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<sup>178</sup> Article 5, the Civil Procedural Law of PRC.

<sup>179</sup> Beligh Elbalti, 'Spontaneous Harmonization and the Liberalization of the Recognition and Enforcement of Foreign Judgments' (2014) 16 *Japanese Yearbook of Private International Law* 264.

<sup>180</sup> Wenliang Zhang, 'Recognition and Enforcement of Foreign Judgments in China: A Call for Special Attention to Both the "Due Service Requirement" and the Principle of Reciprocity' (2013) *Chinese Journal of International Law* 143.

<sup>181</sup> *ibid.*

<sup>182</sup> *ibid.*; Donald C. Clarke, 'The Enforcement of United States Court Judgments in China: A Research Note' (2004) GW Law Faculty Publications & other Work, Paper 1067 <[https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?referer=https://www.google.co.uk/&httpsredir=1&article=2260&context=faculty\\_publications](https://scholarship.law.gwu.edu/cgi/viewcontent.cgi?referer=https://www.google.co.uk/&httpsredir=1&article=2260&context=faculty_publications)> accessed 18 October 2017.

<sup>183</sup> Jie Huang, *Interregional Recognition and Enforcement of Civil and Commercial Judgments: Lessons for China from US and EU Law* (Hart Publishing, 2014) 59.

defendant to compensate him out of his properties in China. The opinion of the Supreme Court was quite simple and clear: it stated that the application should be dismissed since neither the reciprocal relationship nor the relevant international treaties existed between China and Japan, and there was no direct mention of other requirements for recognition and enforcement of foreign judgments under Chinese Law. The Supreme Court's opinion did not bring any clarification to the principle of reciprocity, but it illustrated that reciprocity tends to be one of paramount concern to Chinese courts, and all other requirements appear to be eclipsed by it.

Therefore, according to the restrictive interpretation, when foreign creditors present a foreign insolvency judgment to Chinese courts for recognition under the EBL 2006, and there is no bilateral agreement in existence, they will not be able to collect debt simply because there has been no previous recognition of a Chinese insolvency judgment beforehand in that foreign state. It could be predicted that this would be the situation in a majority of cases. In the context of globalisation and the on-going advancement of the opening-up policy in China, such narrow application of "principle of reciprocity" could cause obstacles in developing an effective international insolvency system.

## **4.6 Conclusion**

In conclusion, because of the historical factors of the centrally planned economy and state-owned enterprises, the early development of the Chinese corporate bankruptcy system has been mainly for political purposes. The Enterprise Bankruptcy Law 1986 was more like a political instrument, and the application of it was mainly based on government orders rather than a court judgment. Although the power of SOEs in the Chinese economy is decreasing and the government is trying to promote the development of the private business sector, SOEs are still a relatively important part of China. Therefore, a certain degree of the tradition of government intervention has been kept under the Enterprise Bankruptcy Law 2006. The ambiguities in the language

of the new law probably provide space for the government to interfere in the proceedings of both SOEs and private enterprises. Article 5 concerning cross-border insolvency under the new law can be a good example of those ambiguities. Although adding the article was a big step forward for China in building an effective bankruptcy system, it still has a long way to go to be clear and practical in application. Specifically, the fact that Article 5 put strict restrictions on granting recognition and assistance to foreign proceedings seems not to be fair to foreign creditors or debtors. Under the development of commercial globalisation, such restrictions could be harmful to Chinese parties' interests in the future.

The bankruptcy law cannot function well on its own. By examining different Chinese laws related to international insolvency issues, it can be found there are basic ideas concerning international insolvency shared by the Chinese legal system and the Model Law regime. In deciding the jurisdiction of opening insolvency proceedings, the Chinese law applies similar principles as the concept of the COMI, which states that proceedings should be opened in the court where the debtor's major business operation is located. Although the basic concepts in China for choice-of-law and recognition issues have something in common with the Model Law, their application in practice have caused uncertainties. Chinese courts tend to connect the choice-of-law issues with jurisdiction. When deciding whether to provide assistance and cooperation to foreign insolvency proceedings, the definition of public policy exception in Chinese needs to be clarified. The tricky problem is the requirement of the existence of judicial assistance agreements and the principle of reciprocity. In particular, the limited number of judicial assistance agreements between China and other jurisdictions does not include any of China's major trading partners. Considering the size of everyday trading between China and different countries, and the fact that many Chinese enterprises are expanding their business overseas, it is possible that such restrictions on the requirements for judicial assistance will eventually backfire on Chinese parties. At least for bankruptcy and commercial matters, judicial assistance should be more attainable. Based on the issues under current Chinese insolvency system, Chinese legal scholars have suggested that

Chinese laws should involve more principles of universalism. Overall, with certain modifications and clarifications, the Chinese legal system has the potential, and could provide a solid foundation to apply the UNCITRAL Model Law system.

## Chapter 5 Hong Kong: Insolvency Law and Its Approach to Solve Cross-Border Insolvency Issues

During the 1970s and 1990s, the economic development of many Asian countries accelerated in pace and started to play a more important role in the international trading platform. With Hong Kong as one of the most significant examples of the development, its annual GDP growth rate being around 10% during that period.<sup>1</sup> Hong Kong's role as an international financial centre also developed significantly during that time. Benefiting from its geographical and economic advantage, Hong Kong has become an investment hub attracting capital from all over the world.<sup>2</sup> More importantly, another reason why Hong Kong attracts vast amounts of foreign investment is that the small island has been the main access route for foreign investors seeking business expansion in mainland China.<sup>3</sup> Similar to its financial position, Hong Kong's legal system also has its uniqueness and would draw the attention of both domestic and international business people and investors. The legal framework of Hong Kong is based on common law, which has been dramatically influenced by the English common law system, and also includes numbers of supplementary local legislation. After the Chinese government resumed sovereignty over Hong Kong in 1997, the legal system became more complicated under the "one country, two systems" system invented by former China leader, Deng Xiaoping.

This Chapter examines how this unique legal and political history and economic position have influenced the forming of a corporate insolvency system, and the attitude toward cross-border insolvency. Section 1 briefly explains the historical and political backgrounds of Hong Kong's legal system. Section 2 reviews the corporate insolvency system of the current legal system. Section 3 explores the solutions for inbound insolvency cases with

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<sup>1</sup> Charles D. Booth, 'Hong Kong Insolvency Law Reform: Preparing for the Next Millennium' (2001) *Journal of Business Law* 126, 156.

<sup>2</sup> John McDermott, 'The Rule of Law in Hong Kong after 1997' (1997) 1 *Loyola of Los Angeles International and Comparative Law Review* 263.

<sup>3</sup> *ibid.*

international elements under the Hong Kong corporate insolvency framework, which mainly includes the recognition of and assistance to foreign insolvency proceedings, and the ability to liquidate unregistered companies in Hong Kong. Finally, section 4 comparatively analyses the Hong Kong insolvency system with the UNCITRAL Model Law regime.

## 5.1 A Brief History of Hong Kong's Legal System

The island of Hong Kong was occupied by the British in 1841. The Chinese government of the Qing Dynasty signed the Treaty of Nanking with the British government in 1842. After the Chinese government ratified the treaty in 1843, Hong Kong was formally ceded to Great Britain. The British government passed the Supreme Court Ordinance in 1844, which officially declared that English law should be applied in the colony of Hong Kong, and that was the first legislation stated in the reception of the English legal system in Hong Kong.<sup>4</sup> Professor Chen indicated that this was the period of time when the foundation for legal pluralism in Hong Kong's legal system was established.<sup>5</sup> In 1966, in order to resolve the complicated procedure of deciding whether the local law or English law will be the applicable law, the Application of English Law Ordinance was introduced, which stated that the English common law and the rules of equity and English Acts of Parliaments should be in force in Hong Kong.<sup>6</sup> The ordinance was a milestone in Hong Kong's legal history. In addition, the ordinance stated that the English law should be applied "so far as they may be applicable to the circumstances of Hong Kong or its inhabitants", which gave the local legislature more discretionary power in using English laws.<sup>7</sup>

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<sup>4</sup> Section 3, Supreme Court Ordinance, No.15 of 1844 (HK).

<sup>5</sup> Chen Lei, 'Legal Culture and Legal Transplants Hong Kong Report', in Jorge A. Sánchez Cordero (ed.) *Reports to the XVIIIth International Congress of Comparative Law* (2011) 1 Article 12, 4.

<sup>6</sup> Section 3 (1), Application of English Law Ordinance 1966 (HK).

<sup>7</sup> Section 3 (1) (a), Application of English Law Ordinance 1966 (HK).

During the nearly 150 years of British control, most of the local ordinances were copies of their English equivalents.<sup>8</sup> The majority of judges, magistrates and law teachers were British. Hong Kong did not have any law schools until 1969, and all the law students from Hong Kong had to go to England to get trained before the teaching of law started locally. Additionally, the language of the court was English. Since the reunification with China, the use of Cantonese and Chinese has become more common in courts; but English still plays the main role in Hong Kong's courts.<sup>9</sup>

In 1984, the UK and Chinese governments signed the Joint Declaration on the Question of Hong Kong, in which the Chinese government officially resumed the exercise of sovereignty over Hong Kong with effect from 1 July 1997.<sup>10</sup> According to the declaration, the PRC's National People's Congress would enact the Basic Law of Hong Kong Special Administrative Region of the People's Republic of China (HKSAR), which serves as a constitutional document in Hong Kong, and regulates the fundamental issues such as how the local government is to be formed and operated, and the sources of laws in HKSAR.<sup>11</sup> The concept of "one country, two systems" was developed during the negotiations between the two countries. It was originally invented to achieve reunification with Taiwan; it envisaged two systems - a socialist system on the mainland and a capitalist system in special administrative regions - co-existing in one country.<sup>12</sup> The two official documents confirmed the implementation of the concept in Hong Kong, which guaranteed "China's socialist system shall not be practised in Hong Kong and that the capitalist system shall remain unchanged for fifty years", along with a high degree of

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<sup>8</sup> Chen Lei (n 5), 8-9.

<sup>9</sup> *ibid*, 8.

<sup>10</sup> Full name: Joint Declaration of the Government of the United Kingdom of Great Britain and Northern Ireland and the Government of the People's Republic of China on the Question of Hong Kong, signed by Premier Zhao Ziyang of China and Prime Minister Margaret Thatcher of the UK in 1984.

<sup>11</sup> Hong Kong SAR, Some Facts about Basic Law, <<http://www.basiclaw.gov.hk/en/facts/index.html>> accessed 20 September 2017.

<sup>12</sup> Ming K. Chan, 'Imperfect Legacy: Defeats in the British Legal System in Colonial Hong Kong' (1997) 18 *Journal of International Law* 133.

autonomy.<sup>13</sup>

One of the most important articles of the Basic Law stated that “the law previously in force in Hong Kong, that is, the common law, rules of equity, ordinances, subordinate legislation and customary law, shall be maintained, except for any that contravene this law, and subject to any amendment by the legislature of the HKSAR”.<sup>14</sup> In preparation for the transfer of sovereignty, the government only made systematic changes in the legal system for fitting it into the Chinese legal framework. For example, the Court of Final Appeal was established to replace the Privy Council as the final appeal court; the Hong Kong Supreme Court had to be changed to the High Court of the HKSAR since the Supreme Court of China is the People's Supreme Court in Beijing. Additionally, some colonial legislation and orders were to be repealed and replaced by new HK legislation. The Basic Law provided a solution for the civil and commercial law of HKSAR to be developed based on the existing common law system.<sup>15</sup> The new legal framework includes English laws that had been applied and were widely accepted in HK, supplemented by the new local legislation. In summary, the application of “one country, two systems” provided Hong Kong with a certain degree of autonomy, and the concept has been marked as “a significant breakthrough for the Chinese political and legal system”.<sup>16</sup> It has been able to provide a stable transfer of sovereignty, as well as maintain the economic freedom and pluralistic culture of Hong Kong society.

## 5.2 Overview of Insolvency System in Hong Kong

Because of historical reasons, the insolvency system in Hong Kong has been heavily influenced by English laws. In 1990, the Law Reform Commission of

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<sup>13</sup> Article 5, Basic Law of HKSAR.

<sup>14</sup> Article 8, Basic Law of HKSAR.

<sup>15</sup> John McDermott, ‘The Rule of Law in Hong Kong after 1997’ (1997) 1 *Loyola of Los Angeles International and Comparative Law Review* 263.

<sup>16</sup> Albert H.Y. Chen, ‘The Theory, Constitution and Practice of Autonomy: The Case of Hong Kong’, in Jorge Oliveira and Paulo Cardinal (ed.) *One Country, Two Systems, Three Legal Orders – Perspectives of Evolution* (Springer 2009).

Hong Kong conducted insolvency law reform, and the insolvency law committee divided the issue into three different parts, being personal insolvency, corporate rescue, and winding-up.<sup>17</sup> As a result, The Bankruptcy Ordinance (BO), which mainly regulates the insolvency of individuals and was developed based on the Insolvency Act 1986 from the UK, was passed in 1996. Matters of corporate insolvency are governed by Winding-up and Miscellaneous Provisions under the Company Ordinance (CO), which is supplemented by the Companies (Winding-up) Rules.<sup>18</sup> Additionally, case law is another important source of law for insolvency issues. For the corporate rescue part, the Reform Commission proposed recommendations in a legislative form of a new chapter ("Provisional Supervision and Voluntary Arrangements") in the CO.<sup>19</sup> However, the legislature did not pass the bill. In the last two decades, the HKSAR government has continually put efforts into drafting the corporate rescue bill and given more attention to the matter. Especially after the Asian financial crisis in mid-1997, the idea of having statutory corporate rescue provisions has received strong support from many professionals and relevant stakeholders.<sup>20</sup> The newly amended bill was announced in 2014, and the target is to introduce the new bill into the legislative procedure in 2018.<sup>21</sup>

### 5.2.1 Winding-up

As with other common law jurisdictions, the definition of corporate insolvency under Hong Kong Law is based on the company's inability to pay its debts. There are three broad considerations to identify whether a company can be

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<sup>17</sup> The Law Reform Commission of Hong Kong, Report of Corporate Rescue and Insolvent Trading (October 1996) 1.

<sup>18</sup> Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32) (HK).

<sup>19</sup> The new chapter was proposed in legislative form as Companies (Amendment) Bill 2000. Please see details in Legislative Council Brief: Companies (Amendment) Bill 2000. <[https://www.legco.gov.hk/yr99-00/english/bc/bc06/general/79\\_brf.pdf](https://www.legco.gov.hk/yr99-00/english/bc/bc06/general/79_brf.pdf)> accessed 12 May 2017.

<sup>20</sup> John Kong Shan Ho and Rohan Price, 'Bringing Corporate Rescue Laws to Hong Kong: A Reform Too Big to Fail' (2011) 12 *Business Law International* 71.

<sup>21</sup> Legislative Council Panel on Financial Affairs, 'Consultation Conclusions on Corporate Insolvency Law Improvement Exercise and Detailed proposals on a new Statutory Corporate Rescue Procedure' CB (1)1536/13V14 (01), 7 July 2014.

wound-up:

- The debtor fails to pay a debt of a sum in excess HK\$ 10000 which is due and subject to written demand (known as Statutory Demand) within 21 days;
- The debtor fails to satisfy a judgment or order of the court in favour of a creditor for a sum of more than HK\$10,000;
- The court believes that it is just and equitable the company should be wound up, taking into account any disputes among shareholders or creditors, or any contingent and prospective liabilities of the company.<sup>22</sup>

When making the decision, the court may apply either the cash flow test or the balance sheet test as they are appropriate in all circumstances. Under the current insolvency system, creditors have different options if the company appears to be in severe financial straits.

### ***Voluntary Winding-up***

A creditors' voluntary liquidation will occur where the company decides to put itself into voluntary liquidation, so there is no certificate of solvency filed, and a special resolution has been passed by the directors.<sup>23</sup> A meeting of creditors must be held on the same day as the meeting of shareholders which passed the special resolution (or the following day), and creditors have control over the winding-up proceeding.<sup>24</sup> There are various formal requirements as to the notice of the relevant meetings of shareholders and creditors. A statement of affairs of the company must be laid before the relevant meeting of creditors, and any nomination of a liquidator by the meeting of creditors will prevail over any contrary nomination by the shareholders.

Hong Kong legislation also contains provisions which allow the directors of a

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<sup>22</sup> For detailed conditions: Section 178, Companies (Winding Up and Miscellaneous Provisions) Ordinance.

<sup>23</sup> Section 233, Companies (Winding Up and Miscellaneous Provisions) Ordinance (HK).

<sup>24</sup> Section 241, Companies (Winding Up and Miscellaneous Provisions) Ordinance (HK).

company to commence a voluntary winding-up without a meeting of members, and such an approach is only available when the company is solvent. This type of winding-up is initiated by a director's resolution that, amongst other things, the company cannot, because of its liabilities, continue its business, and that it is not reasonably practicable to commence the winding-up in any different manner. A statement signed by one of the directors and covering the matters in the resolution must be delivered to the Hong Kong Registrar of Companies within seven days of being made.<sup>25</sup> A director who makes the statement without having reasonable grounds for believing so shall be liable to a fine and imprisonment.<sup>26</sup> Following the delivery of the statement to the Hong Kong Registrar of Companies, a provisional liquidator must be appointed. Subsequently, from the date of the first meeting of creditors onwards, a winding-up under this procedure progresses in the same manner as a creditors' voluntary winding-up commenced by a meeting of members.

### ***Compulsory liquidation***

Compulsory liquidation is initiated with the presentation to the Court of a petition for the winding-up of the company. The petition may be presented by various parties including creditors and the company itself. The party presenting the petition must satisfy certain notice, filing and advertising requirements. On hearing the petition, the Court will make an order for the compulsory winding-up of the company if it is satisfied that one of the following grounds for the Court to wind-up a company exists:<sup>27</sup>

- the company has by special resolution resolved that the company be wound up by the Court;
- the company does not commence its business within a year from its incorporation or suspends its business for a whole year;

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<sup>25</sup> Section 233 (1), Companies (Winding Up and Miscellaneous Provisions) Ordinance (HK).

<sup>26</sup> Section 233 (3), Companies (Winding Up and Miscellaneous Provisions) Ordinance (HK).

<sup>27</sup> Section 177, Companies (Winding Up and Miscellaneous Provisions) Ordinance (HK).

- the company has no members;
- the company is unable to pay its debts
- the event, if any, occurs on the occurrence of which the memorandum and articles provide that the company is to be dissolved; or
- the Court is of the opinion that it is just and equitable that the company should be wound up.

### **5.2.2 Restructuring and Corporate Rescue**

It is not uncommon for creditors of a large company in financial difficulty to attempt to negotiate an informal restructuring agreement with the Company. It is important to emphasise that restructurings can take many different forms. It could be reaching an agreement with the company's banks agreeing to give the company more time to repay its debts; most or all of the creditors need to accept that they probably will never be paid 100% of their debts and the company needs more time to pay. This requires the co-operation of all of the major creditors of the company as, if one of the creditors proceeds to wind up the Company, any agreement reached is likely to be set aside. A restructuring agreement usually includes asset reorganisation and additional investment from the company's shareholders or outside investors in Hong Kong. Statutory procedures such as provisional liquidation and schemes of arrangement can also be used to implement a restructuring proposal.

Despite a large number of restructurings in Hong Kong in recent years, it must be pointed out that the law for restructuring is far from satisfactory. Although the concept of corporate rescue has been well-recognised and corporate rescue regimes have been officially established in many countries, Hong Kong is probably the only financial centre in the world without a formal statutory corporate restructuring mechanism.

#### ***Schemes of Arrangement***

Currently, since there are no formal laws providing methods of company rescue and restructuring, the Scheme of Arrangement, which is governed by section 666 to section 675 under the Companies Ordinance, is the only

statutory method for creditors to achieve a restructuring arrangement. By using such an arrangement, insolvent companies can make a compromise or arrangement with its creditors, or any class of the creditors. Arrangements may include variations of contractual terms, for example, freezing of payment of interest or capital; exchanges of debt for equity in related companies; or payment to unsecured creditors to compromise debts outstanding.<sup>28</sup> Moreover, the using of a scheme of arrangement is not limited to companies in financial difficulties or potential insolvency.<sup>29</sup> The shareholders and/or creditors of any Hong Kong company are free at any time to attempt to reach a binding agreement under the scheme of arrangement procedure.

Before submitting the formal application of the arrangement to the court, the proposed scheme has to be approved by the meetings of creditors or class of creditors or shareholders that may be affected by the scheme.<sup>30</sup> A successful plan has to be accepted by a majority, in number representing 75% in value of the creditors and/or shareholders.<sup>31</sup> Then, the Court has an ultimate discretion whether to sanction any scheme of arrangement, and will consider whether the requirements of the Companies Ordinance have been complied with, whether the majority proposing the Scheme is acting bona fide, and if the arrangement is fair to all creditors in the circumstances.<sup>32</sup> Once the court decides to approve the plan, it will be binding on all creditors or class of creditors.

The advantage of the scheme of arrangement is that the proposed plan does not have to be approved by all the creditors and the effect of the plan is binding on all creditors if sanctioned. However, there are some shortcomings in the method. Firstly, there is no statutory moratorium under the current procedure, so before the plan is approved by the court, it does not stop individual creditors from commencing further actions against the company. For example, secured

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<sup>28</sup> Patrick Yung, 'The Law of Corporate Rescue and Reform in Hong Kong' (2013) 34 (4) *Company Law* 126, 131.

<sup>29</sup> *ibid.*

<sup>30</sup> Section 671-672, Companies Ordinance (HK).

<sup>31</sup> Section 674 (1) (a), Companies Ordinance (HK).

<sup>32</sup> Section 674, Companies Ordinance (HK).

creditors can continue the legal action of seizing the relevant property listed in the loan agreement. Unsecured creditors can also apply for winding-up if the company meets the requirements under the Companies Ordinance for winding-up. Hence, without a moratorium in the insolvency system, it is possible that the effort of negotiating an agreement could be destroyed by individual actions.<sup>33</sup> It is understandable that creditors with priority or with valid security interests are less willing to support restructuring plans since they are already well-protected. Hong Kong practitioners and legal experts have recommended adding a statutory moratorium, which allows the company more time to negotiate a better plan.

### ***Provisional liquidation***

Provisional liquidation itself is a part of the compulsory winding-up procedure, and a provisional liquidator may be appointed to protect the company's assets in the period between the date of filing petition and the date on which any order is to be made. In recent years, insolvency practitioners in Hong Kong have also used the method to facilitate restructuring plans. For instance, since all legal actions against the company automatically stay when the provisional liquidator is appointed, it solves the problem of lack of moratorium in the scheme of arrangement.

The practice of using a provisional liquidator in this particular way was first discussed in *Re Keview Technology (BVI) Ltd.*<sup>34</sup> In this case, the Bank (creditor) presented a wind-up petition and subsequently, provisional liquidators were appointed. If the company were to be wound up, there would be little chance of any recovery for the creditors. However, certain potential investors were proposing a restructuring of certain key elements in the company, which would result in substantial sums becoming available to the company's creditors. The petitioner and the provisional liquidators applied to extend the powers of the provisional liquidators as part of a proposed restructuring exercise. The court pointed out that the participation of

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<sup>33</sup> Patrick Yung (n 28), 131.

<sup>34</sup> *Keview Technology (BVI) Ltd, Re* [2002] 2 H.K.L.R.D. 290 (CFI (HK)).

provisional liquidator in the rescue plan was quite outside the normal powers of the job; nevertheless, the court ruled the power of provisional liquidator could be expanded. Yuen J stated that:

“If the proposed restructuring would be in the best interests of the creditors, given the level of their support for the provisional liquidators participation, and in the absence of any evidence of mismanagement by directors such as would require the company to be wound up without delay for investigations to be done, I see no reason why the court should restrict the powers of provisional liquidators seeking to work out a rescue operation before the court has to determine whether the company should be wound-up.....the above considerations would be consistent with what has been called the rescue culture, what is in effect an attempt to maximise recovery for creditors by saving the company if it is a viable alternative to a minimised recovery on a winding-up”<sup>35</sup>

The judge also emphasised that applying for a provisional liquidator to effect a freeze on actions against the company and facilitate a rescue plan is not abusing the winding-up procedure, thus presenting a positive confirmation of the approach. This innovative way of using the existing legal framework is an excellent example of the flexibility of the Hong Kong Courts to develop an insolvency law where legislation is sometimes too slow to act.

After this case, the decision was widely applied in different corporate insolvency cases in Hong Kong, and courts have become more liberal in appointing the provisional liquidators.<sup>36</sup> However, the opposite view thinks that the appointment of a provisional liquidator is a statutory power and not a common law power, so the court has no authority to extend the power; moreover, the Companies Ordinance states that the provisional liquidator should only be appointed for "conducting the proceedings in the winding-up of a company and performing related duties", which do not include the concept

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<sup>35</sup> *ibid*, para 13-14, per YUEN J.

<sup>36</sup> Patrick Yung (n 28).

of corporate rescue.<sup>37</sup>

### 5.3 Cross-Border Insolvency in Hong Kong

As mentioned in Chapter 2, universalism and territorialism are the two primary approaches for solving cross-border insolvency issues, and it has been discussed that “modified universalism” could be the most acceptable and practical method to be applied by different jurisdictions, since it allows each jurisdiction to apply its substantive insolvency law, but also to exercise discretionary power to cooperate with foreign insolvency proceedings. Under Hong Kong law, since there are no statutory provisions in the Company Ordinance that regulate transnational insolvency issues, modified universalism has frequently been adopted by the Hong Kong courts based on the common law approach.<sup>38</sup> Traditionally, the Hong Kong courts have had very good tradition and willingness to co-operate with foreign insolvency proceedings. The common law power of granting assistance and recognition to foreign insolvency proceedings in Hong Kong was established in 1979, following English case law.<sup>39</sup> The position has been reinforced in recent years with the increasing number of cases that have involved international elements. In a case decided in 2014, *Joint Official Liquidators of A Co v B*, Harris J also emphasised the application of the approach of modified universalism by referencing cases from other common law jurisdictions, saying that “universalism” or “modified universalism” is the main trend in solving international insolvency problems in the common law world.<sup>40</sup>

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<sup>37</sup> Charles D Booth, Stephen Briscoe, and ELG Tyler, *Hong Kong Corporate Insolvency Manual* (3<sup>rd</sup> edn, LexisNexis 2014).

<sup>38</sup> *ibid*, 248-249.

<sup>39</sup> *Modern Terminals (Berth 5) Ltd v States Steamship Co* [1979] H.K.L.R. 512 at 514–521. .

<sup>40</sup> *Joint Official Liquidators of A Company v B* [2014] 4 H.K.L.R.D. 374, para 9–10, per Harris J.

### 5.3.1 Recognition of Foreign Insolvencies

In Hong Kong, because of the distinction between the personal bankruptcy law and corporate insolvency law, the conditions for recognition of foreign bankruptcy and corporate winding-up are also distinguished. Foreign bankruptcy cases can be recognised when declared by a court in the jurisdiction in which the debtor was domiciled at the commencement of the bankruptcy, or the debtor submits to the jurisdiction of the foreign court.<sup>41</sup>

Concerning recognition of foreign winding-up, the general principle is that a foreign order would be recognised if it was made under the law of the place of the company's incorporation.<sup>42</sup> However, similar to the English insolvency law, there are some exceptions to the recognition being granted, including that the debtor conducts business within the jurisdiction of the foreign court and the company submits to the foreign court.<sup>43</sup> Furthermore, it is held that if winding-up is unlikely to happen in the jurisdiction in which the company is incorporated, recognition is also possible to be granted.<sup>44</sup> That was the situation in the case *Re Russo-Asiatic Bank*.<sup>45</sup> The bank was incorporated in Russia and had branch offices in Shanghai, London, and Hong Kong. The Hong Kong court followed the English approach held that there was no winding-up proceeding in the jurisdiction of incorporation, and no other court could be regarded as the principal court to govern the winding-up. But the court granted the recognition to the English liquidation of the bank's London branch permitting the London appointed liquidator to submit claims of English creditors.

If the foreign proceeding fulfils the conditions discussed above, Hong Kong

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<sup>41</sup> *Modern Terminals (Berth 5) Ltd. v. States Steamship Co.* [1979] H.K.L.R. 512, 514-521.

<sup>42</sup> *Re Irish Shipping* [1985] H.K.L.R. 437, 439.

<sup>43</sup> Charles D. Booth, 'The Transnational Aspects of Hong Kong Insolvency Law' (1995) 2 *SW.J.L. & Trade Am.* 1; Charles D. Booth, 'Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law' (1996) 34 *Columbia Journal of Transnational Law* 389.

<sup>44</sup> *ibid.*

<sup>45</sup> *Re Russo-Asiatic Bank* [1930] 24 H.K.L.R. 16.

courts also have the right to refuse the recognition if the recognition would be contrary to local public policy, or the foreign insolvency decree has been made as a result of fraud or in breach of the rules of natural justice, or the foreign proceedings are an attempt to enforce a foreign penal or revenue law.<sup>46</sup> The *Joint Administrators of African Minerals Ltd v Madison Pacific Trust Ltd* would be a good example to show the grounds for refusing recognition. In this recent case, the Hong Kong court refused to grant assistance to administrators appointed by the English court on the grounds that there were no equitable principles under Hong Kong local law. With an administration order from the English court, the administrators sought assistance from the Hong Kong court to restrain the enforcement of security over the shares controlled by the security agent in Hong Kong. The court held that the purpose of the moratorium created by the administration order in the UK was to prevent disposal of the company's assets in that jurisdiction, but there is no equivalent of the UK administration process under the local law, and no statutory provision for providing a moratorium on enforcement of the secured debt.<sup>47</sup> Therefore, the administrator's application for assistance was refused. The judge pointed out that although the court can have a generous view of assisting foreign proceedings, the power should be limited within the local insolvency regime and common law and equitable principles.<sup>48</sup> The legal reasoning from *Singularis Holdings v PricewaterhouseCoopers* was applied here, which held common law power of assisting cross-border insolvency is subject to local statutory and common law rules and public policy.<sup>49</sup>

However, Harris J also pointed out that although a moratorium on enforcement of security cannot be provided because Hong Kong does not have a similar arrangement, a similar effect to recognising an administration order can be achieved by way of injunction; for example, if it could be proved that the

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<sup>46</sup> Charles D. Booth and others (n 37), 249.

<sup>47</sup> *ibid*, para 12.

<sup>48</sup> *ibid*, para 11.

<sup>49</sup> *Singularis Holdings v PricewaterhouseCooper* [2014] UKPC 597, para 19 per Lord Sumption.

proposed enforcement would improperly prejudice the equity of redemption.<sup>50</sup> This shows that even if the common law powers might sometimes be limited, Hong Kong judges are prepared to offer assistance in a pragmatic manner.

### **5.3.2 Winding up an Unregistered Company**

It is held that the Hong Kong courts have the inherent jurisdiction to assist a foreign representative from any jurisdiction, including recognising their appointment and powers over the insolvent company's assets.<sup>51</sup> Therefore, commencing a winding-up to reach a foreign company's assets in Hong Kong may not be necessary. However, foreign representatives should consider filing a winding-up petition in a Hong Kong court if they cannot receive sufficient assistance from non-winding up approaches, or if the unsecured creditors would benefit from some of the effects of the proceeding that is not available under other approaches. Those effects may include that the stay of legal actions or proceedings against the company once the winding-up order has been made, or a provisional liquidator has been appointed, or the powers to conduct a detailed investigation of the avoidance of uncompleted attachments or executions.<sup>52</sup>

Under the company law of Hong Kong, all the companies incorporated outside of Hong Kong are referred to as non-Hong Kong companies, and can be wound-up as unregistered companies, according to Part X of the Winding Up and Miscellaneous Provisions under Company Ordinances.<sup>53</sup> Section 326 defines the meaning of "unregistered companies," which includes any

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<sup>50</sup> *Administrators of African Minerals Limited v. Madison Pacific Trust Limited* [2015] 4 HKC215, para 12 per Harris J.

<sup>51</sup> Robert-Jan Temmink and Turlough Stone, 'The Hong Kong Court Looks at the 'Sufficient Connection' Test to Liquidate Foreign Registered Company' (2016) 13 *International Corporate Rescue* 157.

<sup>52</sup> Companies (Winding Up and Miscellaneous Provisions) Ordinance: Section 221 Power to summon persons suspected of having the property of the company; Section 222 Power to order public examination of promoters, directors, etc; Section 269 Restriction of rights of creditor as to execution or attachment in case of company being wound up (HK).

<sup>53</sup> Companies (Winding Up and Miscellaneous Provisions) Ordinance (HK).

partnership, limited partnership, association, and company.<sup>54</sup> Section 327 makes it clear that any unregistered company may be wound up under the law, with exceptions such as an unregistered company which may not be wound voluntarily, and subsection (3) provides the conditions for winding-up:

- (a) If the company is dissolved, or had ceased to carry on business, or is carrying on business only for the purpose of winding up its affairs;
- (b) If the company is unable to pay its debts
- (c) If the court is of the opinion that it is just equitable that the company should be wound up.

Additionally, subsection (4) provides detailed conditions of proving an unregistered company's inability to pay its debts.<sup>55</sup>

There is no provision under Part X allowing foreign representatives to open winding-up proceedings, but in practice, the court has allowed petitions by foreign representatives on behalf of foreign companies. The court held that where a foreign representative decides that it would be beneficial to wind-up the foreign company in Hong Kong, he must either convince one of the foreign company's creditors to file a petition or petition himself on behalf of the foreign company. The latter approach is more common and was adopted recently.<sup>56</sup>

### **5.3.2.1 Jurisdiction**

The jurisdictional connection between the foreign company and Hong Kong is not required for a Hong Kong court to wind-up the company, so the court's decisions on this matter could vary from case to case. Traditionally, the jurisdiction to wind-up a foreign company in Hong Kong is based on the presence of assets. The basis was discussed in a notable Hong Kong case, *Re Irish Shipping*.<sup>57</sup> The court confirmed that it is sufficient to found

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<sup>54</sup> *ibid*, Section 326 Meaning of unregistered companies.

<sup>55</sup> *ibid*, Section 327 Winding up of Unregistered Companies.

<sup>56</sup> *Re Information Security One Ltd* [2007] 3 H.K.L.R.D 780.

<sup>57</sup> *Re Irish Shipping* [1985] H.K.L.R. 437.

jurisdiction if there are assets in Hong Kong when the petition is heard.<sup>58</sup> Furthermore, after this case, it was discussed that the time for deciding the jurisdiction should be the date that the winding-up petition is presented.<sup>59</sup> However, with social and legal developments, it became accepted that the presence of assets is not the sole basis for winding-up foreign companies. The test of sufficient connection is held to be more effective in resolving modern international issues.<sup>60</sup> By referencing the English decision on this issue, there are three core requirements for courts winding up foreign companies.<sup>61</sup> In a recent case, *Pioneer Iron and Steel Group Co Ltd*,<sup>62</sup> the Hong Kong Court confirmed the court's discretionary jurisdiction to wind-up an unregistered company under s.327 and reinforced the three core requirements:

1. there is sufficient connection with Hong Kong (in the context of insolvency this is commonly indicated by the presence of assets, but this is not essential);
2. there is a reasonable possibility that the winding-up order would benefit those applying for it, and
3. the court must be able to exercise jurisdiction over one or more persons interested in the distribution of the company's assets.

In addition, the judge also emphasised that the court should apply those requirements according to the different facts of specific cases, Harris J said that:

“The significance of each requirement will vary from case to case. An exceptional case may arise in which the connection with Hong Kong is so strong and the benefits of a winding-up order for creditors of a company so substantial that the court will be willing to exercise its jurisdiction despite the

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<sup>58</sup> *Re Irish Shipping* [1985] H.K.L.R. 437 at 444.

<sup>59</sup> Charles D. Booth, 'Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law' (1996) 34 *Columbia Journal of Transnational Law* 389.

<sup>60</sup> Charles D Booth and others (n 37), 255-257.

<sup>61</sup> *Re Real Estate Development Co* [1991] B.C.L.C. 210 Ch D.

<sup>62</sup> *Re Pioneer Iron and Steel Group Co Ltd* [2013] HKEC 317.

third criteria not being satisfied.”<sup>63</sup>

Such a situation described by Harris J happened not long after the *Pioneer* case was decided. The liquidator appointed by the Cayman Islands liquidation proceedings in the *China Medical Technologies* case sought to wind up the company in Hong Kong, and to use the extensive examination powers and avoidance provisions under Hong Kong company ordinances.<sup>64</sup> While the first two requirements were met, the third one was the main issue here. The relevant fact was that the debtor owed US\$4,139 to a Hong Kong law firm, which was only a tiny amount of its total outstanding debts of US\$40 million. Following his judgment from the previous case, Harris J stated that the discretionary power of applying the three requirements could be moderated if the circumstances explicitly call for it, and for the current case: "unless the connection with Hong Kong is very strong and the benefits to creditors substantial, the petition fails."<sup>65</sup> In order to prove the very strong connection, the court should be satisfied that Hong Kong was apparently central to the company's principal activities. The judge held that it failed to prove that, so the connection with Hong Kong was not strong enough to ignore the third requirement. Nevertheless, the case was re-opened, and the winding-up petition was granted because of the submission of important new evidence showing the company's strong connection with Hong Kong.

Based on this case, the judge further clarified the application of the three requirements. First, the general rule is that all the three requirements should be satisfied for the Hong Kong court to exercise jurisdiction over the unregistered company. Regarding the third requirement, it will be fulfilled if there are persons with sufficient connection with Hong Kong other than just the petitioner or a creditor, and sufficient economic interests in the local winding-up: for example, if one creditor or a group of creditors hold a substantial portion of the debt owned by the debtor. Secondly, Judge Harris also emphasised the role of the three core requirements in determining

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<sup>63</sup> *ibid*, Harris J, para 28.

<sup>64</sup> *Re China Medical Technologies, Inc* [2014] 2 HKLRD 997.

<sup>65</sup> *Re China Medical Technologies, Inc* [2014] 2 HKLRD 997, para 55, per Harris J.

whether to exercise jurisdiction. The core requirements constitute guidance for the court to be observed in applying jurisdiction, rather than pre-conditions for the existence of the jurisdiction.<sup>66</sup> This is relevant when courts need to decide whether to use the discretion to wind-up an unregistered company. Finally, it would be in exceptional cases that courts were to grant the winding-up where the third requirement was not satisfied. In order to do that, the court should be satisfied that the first and second conditions are sufficiently fulfilled; additionally, whether Hong Kong is central to the company's principal activities is another issue that the local court will look at.<sup>67</sup>

Since the consideration of sufficient connection has been well-developed and accepted, one confusion may be raised about the application of the presence of an assets test. The argument is about whether the presence of assets is still an independent basis for a Hong Kong court to exercise jurisdiction over foreign companies, or whether it is an element to be considered under the sufficient connection approach. Currently, it seems that the latter opinion was adopted by the courts, and the court said the fact that a foreign debtor's assets are in Hong Kong is relevant in considering whether there is sufficient connection.<sup>68</sup>

In the case *Zhu Kuan Group Co Ltd*, the judge discussed the connection between the presence of assets and the test of sufficient connection. The judge cited the three core requirements from the English authority while discussing the foreign company's assets located in Hong Kong, saying that "it seems to me that the existence of assets within the jurisdiction may.....serve to demonstrate a real connection between the company whose winding-up is petitioned for and Hong Kong, thus satisfying the first core requirement - that there should be shown to be a sufficient connection with Hong Kong".<sup>69</sup> So it was clear the court treats assets in Hong Kong as an important factor regarding satisfying those core requirements. However, the decision was

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<sup>66</sup> *Re China Medical Technologies, Inc* [2014] 2 HKLRD 997, para 50, per Harris J.

<sup>67</sup> *Re China Medical Technologies, Inc* [2014] 2 HKLRD 997, para 58, per Harris J.

<sup>68</sup> *Re Zhu Kuan Group Co Ltd* [2004] HKCU 1047.

<sup>69</sup> *ibid*, para 30.

criticised by Professor Charles D Booth saying that combining two jurisdictional tests into one was an "unfortunate development," and would encourage jurisdictional battles.<sup>70</sup> He thinks the Hong Kong courts misunderstand the purpose of the sufficient connection test introduced by the English authority, which is to provide some flexibility in situations where a foreign company does not have assets in England.<sup>71</sup> For a certain number of cases, foreign debtors' assets located in the jurisdiction could be self-evident, so parties do not need to prove that, and should pay more attention to arguing whether the court should exercise its discretion. By applying the approach adopted in the case, the need for courts to analyse the significance of debtors' assets in Hong Kong would be frequent, which is apparently not an effective approach to solving cross-border insolvency.

### **5.3.2.2 The New Development of Offshore Companies Cases**

Regarding the winding up of unregistered companies in Hong Kong, one problematic situation is related to the filing of offshore holding companies from jurisdictions such as the Cayman Islands or the British Virgin Islands (BVI). It cannot be denied that having a holding company in those jurisdictions has been a valuable commercial feature in Hong Kong and the global business community since such companies offer benefits including assets security, tax-neutral status, and flexibility in dealing with company matters.<sup>72</sup> As a place famous for successful family-owned companies, the normal structure of those Hong Kong family-owned companies is that businesses and assets are held directly or indirectly by a foreign offshore parent company.<sup>73</sup> With the unstable global economic condition in recent years, the number of cases seeking such

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<sup>70</sup> Charles D Booth and others (n 37), 259.

<sup>71</sup> *ibid.*

<sup>72</sup> Mourant Ozannes, 'Yung Kee – an Offshore Perspective: The Winding up of BVI and Cayman Islands Companies in Hong Kong' (May 2013), *Mourant Ozannes*, <<https://zh.scribd.com/document/160156199/Yung-Kee-an-Offshore-Perspective-the-Winding-Up-of-Bvi-and-Cayman-Islands-Companies-in-Hong-Kong>> Accessed 4 September 2017.

<sup>73</sup> Fu-Lai Tony Yu and Diana S. Kwan, 'Family Business Succession in Hong Kong: The Case of Yung Kee' (2013) 7 *Frontiers of Business Research in China* 433.

holding companies to be wound-up in the Hong Kong courts is increasing.

Those companies generally do not carry out any principal business activities in Hong Kong; therefore, according to the analysis above, petitions to wind up those companies would possibly be held unsuccessful on the grounds of insufficient connection with Hong Kong. In such a situation, shareholders have to focus on seeking remedies from the court of the company's place of incorporation, with sufficient legal expenses and time. However, a case in 2015 decided by the Hong Kong court, *Kam Leung Sui Kwan v Kam Kwan Lai* (also known as the *Yung Kee* case), could be a changing point on this matter, as it took a noteworthy step forward in allowing local courts to exercise jurisdiction over offshore companies under the sufficient connection requirement.<sup>74</sup>

In that case, Yung Kee was a very famous traditional restaurant in Hong Kong. The holding company of the restaurant was called Yung Kee Holding Ltd (YKHL), which was incorporated in the British Virgin Islands and was not registered under the Company Ordinances. Not long after the death of the founder, his two sons, who were the two major shareholders of the company, ultimately fell out with each other. The son with the minority shareholding brought a petition against his brother and YKHL, seeking an order from the Hong Kong Court to force his brother to buy out his shareholding, or alternatively to order the winding-up of the company, on the grounds that the operation of the company had been conducted in a manner unfairly prejudicial to him as a member, which is one of three grounds to wind up unregistered companies under s.327.<sup>75</sup> Both the first instance and appeal courts ruled that the Hong Kong Court had no jurisdiction to make either the order to enforce the buy-out or the order to wind-up the foreign company without sufficient connection with Hong Kong.

Although the restaurant and other family businesses are in Hong Kong, the

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<sup>74</sup> *Kam Leung Sui Kwan v Kam Kwan Lai and others* [2015] HKCFA 91; FACV 4/2015.

<sup>75</sup> Section 327 (3) (c). Company (Winding Up and Miscellaneous Provisions) Ordinance (HK).

court held that the BVI holding company did not directly hold those businesses or properties, and it was a parent company of another BVI company which was directly holding those assets. Therefore, the judge considered that the company in question was an investment holding company with no assets, business operations or connections with Hong Kong. The presence of money in a Hong Kong account and the use of local banks could not satisfy the requirement of sufficient connection. The court further emphasised that, although the Hong Kong courts had been generous about assisting foreign insolvency proceedings and winding-up unregistered companies, it was still an exorbitant power to wind-up a company incorporated in another jurisdiction, and this power should only be used in exceptional circumstances.<sup>76</sup> The courts should not make loose interpretations of the meaning of "sufficient connection." The case was appealed to the court of final appeal.

At the end of 2015, the court of final appeal made a significant ruling, which stated that the requirements for sufficient connection had been met and the winding-up order was made by the court; however, the court also gave the parties 28 days to consider the opportunity of buy-out as an alternative to winding-up. The judgment overturned the decision and analysis about the discretion of exercising jurisdiction over offshore holding companies and explained in detail how to build the connection between offshore companies and Hong Kong.

In order to build such a connection, the crucial first point that should be noticed is the differences between the creditor's petition and the shareholder's petition. The starting point is that:

"Shareholders, no less than creditors, are entitled to bring winding-up proceedings in Hong Kong.....and in either case, they must establish a sufficient connection between the place of incorporation and Hong Kong."<sup>77</sup>

The two factors distinguishing the two different types of petitions are the

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<sup>76</sup> *Re Yung Kee Holdings Ltd* [2014] 2 HKLRD 313 (CA).

<sup>77</sup> *Kam Leung Sui Kwan v Kam Kwan Lai and Others* [2015] HKCFA 91, para 26.

nature of the dispute and the purpose for seeking the winding-up order. In the case of a petition brought by a creditor, the dispute is between the petitioner (creditor) and the company.<sup>78</sup> But in a shareholder's petition, the dispute is between the petitioner (shareholder) and other shareholders, so the company is a subject of, rather than a party to, the dispute.<sup>79</sup> With regard to the purpose, creditors are looking to winding-up to repay their debts, and the shareholders' main purpose is to realise their investment in the company.<sup>80</sup> Accordingly, for a shareholder's petition, such as in the current case, the presence of shareholders in the jurisdiction should be a critical factor to be considered in deciding whether there is sufficient connection between the company and jurisdiction; as the judge stated, "their presence in the jurisdiction is highly relevant and will usually be the most important single factor".<sup>81</sup>

Secondly, the court clarified that, although the companies and shareholders are "separate and distinct legal entities", which was one of the main reasons why the lower courts established an insufficient connection analysis, it does not mean there is no connection between them.<sup>82</sup> Such a connection could be established through shareholders or subsidiaries. The court recognised the close connection between a holding company and the assets of its direct and indirect subsidiaries, and said that "there is no doctrinal reason to exclude a connection through a wholly owned subsidiary".<sup>83</sup> Furthermore, the court of final appeal also emphasised that three core requirements are not statutory but self-imposed constraints adopted by the court, so the application is not about its legal interpretation, but a question of degree.<sup>84</sup> The court should

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<sup>78</sup> *ibid*, para 27.

<sup>79</sup> *ibid*.

<sup>80</sup> *ibid*.

<sup>81</sup> *ibid*.

<sup>82</sup> *ibid*, para 34.

<sup>83</sup> *ibid*; *Waddington Ltd v Chan Chun Hoo* [2008] 11 HKCFAR 370; Paul Apáthy, Emmanuel Chua and Truman Biro, 'Recognition of Foreign Insolvencies at Common Law: Singapore Sets COMI Precedent' (12 August 2016), *Herbert Smith Freehills* <<https://www.herbertsmithfreehills.com/latest-thinking/recognition-of-foreign-insolvencies-at-common-law-singapore-sets-comi-precedent> > accessed 4 September 2017.

<sup>84</sup> *Kam Leung Sui Kwan v Kam Kwan Lai and others* [2015] HKCFA 91 at [36].

make decisions based on the specific material facts since the nature of the connection will vary from case to case.

The milestone decision from the Hong Kong court of final appeal extended the discretionary power of exercising jurisdiction in the winding-up of offshore companies. The judgment will benefit shareholders based in Hong Kong looking to wind-up foreign holding companies with assets held in Hong Kong, particularly for those offshore companies holding Hong Kong assets through wholly owned subsidiaries, which can be a very common corporate structure for Hong Kong businesses. In addition, the considerable flexibility in applying the three core requirements for the sufficient connection test shows that Hong Kong courts are willing to examine all the relevant facts involving foreign companies, and to review and consider all possible options with an appropriate degree of discretion. Under the principle of modified universalism, Hong Kong courts have increasingly shown they are prepared to co-operate and assist.

### **5.3.2.3 Secondary Proceedings in Hong Kong**

After the jurisdiction requirement has been satisfied, the courts have to decide whether to grant the winding-up order. Under common law, the courts have the discretion to dismiss a winding-up petition and not make the order. For instance, the court might refuse to make the order on the grounds that Hong Kong is not the most appropriate forum for the issue. As we discussed above, Hong Kong courts have been applying modified universalism under the common law to solve cross-border insolvency cases, which allows the recognition of foreign insolvency proceedings and the commencement of an independent local proceeding in Hong Kong. This should be distinguished from the two different secondary proceedings that might proceed in Hong Kong.

The first type is ancillary insolvency, which means that the courts think it would be best to act as an assistant proceeding to the foreign proceeding, and would like to cooperate with the liquidator in the collection and preservation of the

assets in Hong Kong.<sup>85</sup> In such a situation, the court considers more about what types of cooperation could be provided rather than whether the winding-up order should be made. Hence, the court will deal with the case by using Hong Kong's substantive insolvency law; after paying the expenses of the local proceeding, an order might be made to turn over the surplus assets to the foreign proceeding for distributing to all creditors of the foreign company.<sup>86</sup> In *Irish Shipping*, the court discussed the conditions in which such ancillary proceedings could be granted. Firstly, there should be satisfactory reasons given by the creditors who oppose the local winding-up order. Secondly, the court must consider the interests of the unsecured creditors and public interests. Thirdly, the court should consider the "comity of nations whereby it is desirable that the court should assist the liquidator in another jurisdiction to carry out his duties, unless good reasons to the contrary have been put forward".<sup>87</sup>

The second type is concurrent insolvency. Once the court found that the connection between the foreign company and foreign proceeding are not substantial enough to justify the ancillary proceeding, a total independent winding-up proceeding would be ordered. Under such an approach, each proceeding will deal with assets located in its jurisdiction, and make payments to creditors in a separate proceeding. However, cooperation still can be achieved; for example, the liquidator appointed by the Hong Kong court may reach an agreement with the foreign liquidator about distribution among creditors, and once such an order is approved by the court, worldwide distribution is still possible.

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<sup>85</sup> Charles D. Booth and others (n 37), 260-262.

<sup>86</sup> *ibid.*

<sup>87</sup> *Re Irish Shipping Limited* [1985] HKLR 437, 439.

## 5.4 Comparative Analysis of the UNCITRAL Model Law

Hong Kong's legal community and courts are no stranger to the UNCITRAL Model Law on Cross-Border Insolvency. The first time the official document discussing the United Nations proposed system was acknowledged was in the Report on the Winding-up Provisions of the Companies Ordinance published in 1996.<sup>88</sup> The Law Reform Commission stated that harmonising the laws of insolvency internationally should be encouraged, and the system introduced by the UNCITRAL was favourable to providing a modern, harmonised and fair legislative framework to address more effectively instances of cross-border insolvency; however, since the development and application of the law was still at an early stage, the commission thought Hong Kong should be cautious about its adoption and that "watch and wait" was probably a good idea, until more leading jurisdictions adopting the law.<sup>89</sup> Nevertheless, the commission also pointed out that enacting the law would be beneficial to Hong Kong business interests, and Hong Kong's decision on this matter would undoubtedly influence neighbouring jurisdictions; it also suggested that in redrafting the winding-up provisions, the broad definitions provided in the UNCITRAL Model Law guide should be considered.<sup>90</sup> In recent years, with the increasing number of international insolvency cases filed in Hong Kong, the local judges have frequently made references to the Model Law approaches, or to the cases from other common law jurisdictions where decisions have been made based on the Model Law; more importantly, the judges generally expressed their agreement over the system proposed by the law.<sup>91</sup> Since there are no statutory regulations relating to cross-border insolvency and all legal principles are from common law, it seems that the

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<sup>88</sup> The Law Reform Commission of Hong Kong, Report on the Winding-up Provisions of the Companies Ordinance, published in 1996, <<http://www.hkreform.gov.hk/en/docs/rwind-e.pdf>> accessed 12 March 2017.

<sup>89</sup> *ibid*, Chapter 26-Winding-up of Unregistered Companies (Cross-border Insolvency).

<sup>90</sup> *ibid*.

<sup>91</sup> See, for example, discussion of Harris J in *Re Pioneer Iron and Steel Group Co. Ltd.* [2013] HKCFI 324, para 44; *The Joint Official Liquidators of A Company v B* [2014] 4 HKLRD 374.

solutions Hong Kong courts applied share some similarities with the UNCITRAL Model Law.

#### 5.4.1 Recognition

Recognition is one of the main features of the Model Law, which aims to provide an effective system for recognising foreign insolvency proceedings.<sup>92</sup> Under the law, a local court may recognise the foreign proceedings as foreign main proceedings or non-main proceedings, and the concept of centre of main interests (COMI) will be applied here to make the decisions. Article 16 provides the general rule of deciding if the location of the COMI is the debtor's registered office, which can be rebutted if there is clear evidence showing the COMI is located somewhere else. Under common law powers in Hong Kong, the courts have the right to recognise foreign proceedings opened in the jurisdiction where the company is incorporated. Therefore, the starting point of recognition under both systems is the incorporation place of the debtor. The difference is that there is some automatic relief under the Model Law after the recognition is granted, in order to protect local assets, and the relief or assistance that Hong Kong courts may be granted are discretionary.

One of the main reasons that the Model Law applied the COMI was to face the modern business development that one company's registered place and its main managerial and operational centre are not necessary at the same location.<sup>93</sup> By using the COMI, it could prevent forum shopping and make sure that there is sufficient connection between the debtor and the jurisdiction governing the insolvency proceeding. There is no similar rule in Hong Kong common law dealing with such a situation, so it is still unclear whether the Hong Kong court would recognise a foreign proceeding from the jurisdiction where the debtor's central business operation is located, but not the place of its incorporation. Since the Hong Kong law allows courts to liquidate foreign

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<sup>92</sup> Sandeep Gopalan and Michael Guihot, 'Recognition and Enforcement in Cross-Border Insolvency Law: A Proposal for Judicial Gap-Filling' (2015) 48 *Vanderbilt journal of transnational law* 1226.

<sup>93</sup> Stephanie L. Warner, 'Cross-Border Insolvency: The COMI Issue in the Stanford Case' (2011) *International and Comparative Bankruptcy* 17.

companies with extended jurisdiction rules, the local creditors or shareholders could apply for winding-up proceedings if such a situation happens; but if the proceeding in the most appropriate forum already exists, applying for recognition and assistance could be more effective.

Recognition cases involving offshore companies have drawn a lot of attention in the area of cross-border insolvency. As a financial and commercial centre in the area, there is no doubt that Hong Kong courts also face a similar question. As discussed in the last part, the Hong Kong courts have adopted a very pragmatic approach in deciding jurisdiction issues for offshore companies. Although there is no reported case in Hong Kong dealing with the recognition issue concerning those companies, Hong Kong judges should be made aware of a case recently decided in Singapore, which might influence them. In the case, *Re Opti-Medix Ltd*, a Singaporean judge who decided to grant recognition to a Japanese bankruptcy proceeding applied the COMI consideration under the common law.<sup>94</sup>

The company in question was incorporated in the British Virgin Islands, but was conducting businesses mainly in Japan. The business activities were unprofitable, and the trustee was appointed by the Japanese court. The trustee needed to gain access to the bank accounts and funds of the company in Singapore, so sought orders that the court recognises the Japanese trustee in bankruptcy and provide assistance in collecting the assets in Singapore. The trustee argued that it was unlikely that an insolvency proceeding would be opened in the BVI, and the Japanese court should be considered the principal court of insolvency; moreover, since the idea of COMI has become well accepted because of the Model Law, the Singapore court should consider that the COMI of the company is in Japan. The court held the COMI of the company was in Japan and granted the recognition.

Since there is no other authority of common law on this matter, and it would influence other common law countries which have not adopted the UNCITRAL Model Law, the judge gave a careful analysis of applying the COMI in common

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<sup>94</sup> *Re Opti-Medix Ltd and Another Matter* [2016] SGHC 108.

law. First, the judge made references to the English case *HIH Casualty and General Insurance Ltd*,<sup>95</sup> in which Lord Hoffmann stated that in some cases in which the place where the company is incorporated may be some offshore islands with which the company's business has no real connection, using the COMI test may be more appropriate.<sup>96</sup> Then, regarding whether the COMI should be applied under common law, the court agreed with the Model Law approach, and stated that the registered office rule is a sound default rule in the absence of evidence to the contrary.<sup>97</sup> Additionally, the judgment also mentioned that Lord Collins in *Rubin v Eurofinance* doubted Lord Hoffmann's approach, saying that it would open a way for the courts to introduce a new basis for recognition concerning insolvency proceedings, and such a matter should be resolved by the legislature.<sup>98</sup> The Singapore judge disagreed with Lord Collins, and provided that the development of common law should not be "so constrained", and there was no difficulty in applying a broader test based on COMI under common law.<sup>99</sup>

The case from Singapore sets the precedent of using the COMI test as grounds for recognition of foreign insolvency proceedings. The approach implies that the common law should develop in the face of new developments in the commercial and legal world, and the COMI test could be a necessary supplement to the traditional approach of the place of the incorporation test. More importantly, since the decision may not be that influential in other main common law jurisdictions which have already adopted the Model Law, it would be interesting to see whether the Hong Kong judge would apply the Singaporean approach. The answer would probably be affirmative.

Firstly, the two jurisdictions share many similarities. Both legal systems were established based on the English common law system, and common law principles generally are their main source for solving cross-border insolvency

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<sup>95</sup> *Re HIH Casualty and General Insurance Ltd* [2008] 1 W.L.R. 852 HL.

<sup>96</sup> *ibid*, para 31, per Lord Hoffmann.

<sup>97</sup> *Re Opti-Medix Ltd* [2016] SGHC 108, para 25.

<sup>98</sup> *Rubin v Eurofinance SA* [2013] 1 AC 236, para 129 – 130, per Lord Collins.

<sup>99</sup> *Re Opti-Medix Ltd and Another Matter* [2016] SGHC 108, para 21-22, per Abdullah JC.

issues.<sup>100</sup> More importantly, they are both very important international financial centres, so it is common that insolvent companies have assets or operations in those locations. The issues relating to offshore companies could happen more often under both courts. Secondly, with the reality that there are no prospects of the Model Law being adopted any time soon in Hong Kong, such an approach would give the court broader powers to recognise and assist foreign proceedings. Furthermore, the decision would harmonise the results regarding common law and the statutory application of the COMI test, which improves the certainty and predictability for cases involving Hong Kong and other jurisdictions that have adopted the Model Law. Thirdly, according to the Hong Kong approach dealing with jurisdiction over offshore companies, it is clear that the courts have realised the issues to which such companies could give rise. With co-operative and practical attitudes in dealing with international insolvency, the Hong Kong courts seem to have no reason not to follow the Singaporean precedent.

Overall, the basic rule of recognition under the Hong Kong common law and the UNCITRAL Model Law are the same. With the new authority of applying the COMI in common law, which could easily be applied in Hong Kong, similar results under the Model Law could be achieved in Hong Kong.

#### **5.4.2 Cooperation and Assistance**

Although the Hong Kong courts have been showing willingness to cooperate with foreign insolvency proceedings, and this could potentially achieve similar results to the UNCITRAL Model Law, some specific issues that could be vital to cross-border insolvency are still unclear under Hong Kong common law principles; for example, the power of the court to stay and restrain proceedings against the debtor at a time after the application of the recognition of foreign proceeding and before the decision of the recognition. Under the Model Law, Article 19 gives the recognising courts the discretionary power to grant

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<sup>100</sup> It should be noted that the Singapore parliament has passed Companies (Amendment) Act in early 2017, which adopted the UNCITRAL Model Law on Cross-Border Insolvency.

"urgently needed relief" upon application for recognition of foreign proceedings, in order to protect the assets of the debtor and the interests of creditors before the decision of recognition.<sup>101</sup> Under current Hong Kong statutory law, such powers only exist when there is an application for local winding-up proceedings.<sup>102</sup> Since currently, case law has not clarified such a matter, to protect local assets or to look for avoidance or investigatory powers, the foreign representatives should choose to open a local winding-up proceeding. Although the courts have been flexible about the jurisdiction connection between foreign companies and Hong Kong, it does not mean the winding-up order will be granted for sure with the satisfaction of the jurisdiction test. For example, the court could refuse the petition because there is a more appropriate forum in which a proceeding should be opened.

In one case, an English creditor of a Chinese mainland company filed a winding-up petition in Hong Kong, looking for the company to be wound-up based on section 237 as an unregistered company.<sup>103</sup> The court approved the petition and said that sufficient connection could be built because there are some individual shareholders of the company in Hong Kong and the company's worldwide investment included companies that were located in Hong Kong. The decision has been criticised for two reasons. Firstly, the proper forum to open the insolvency proceeding should be China since it is the company's place of incorporation and principal place of business. Secondly, the dispute between the English creditor and the company had no connection with Hong Kong, and the Hong Kong proceeding was only part of the creditor's international debt enforcement strategy. Therefore, opening local proceedings in Hong Kong may be not always be guaranteed. Furthermore, compared with the UNCITRAL Model Law system allowing protective relief before recognition is granted, the legal approach under the

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<sup>101</sup> Article 19, UNCITRAL Model Law on Cross-border Insolvency.

<sup>102</sup> Section 329, Company (Winding Up and Miscellaneous Provisions) Ordinance (HK).

<sup>103</sup> *Re China Tianjin International Economic and Technical Co-operative Corp* [1994] 2 HKRL 327.

Hong Kong law is not that effective.

Another issue that needs to be clarified is the Hong Kong common law principle about the power to grant cooperation and assistance to foreign proceedings. As mentioned above, the Hong Kong judges and lawmakers have said on different occasions that modified universalism is the main approach to solving cross-border insolvency issues, which means the courts need to provide assistance for foreign proceedings as they think it is appropriate. In *the Joint Official Liquidators of A Company*,<sup>104</sup> when discussing the common law power to assist foreign insolvency proceedings, the judge agreed that foreign liquidators should be empowered to assert in Hong Kong whatever claims that are available to them under their jurisdiction of appointment if the foreign substantive law to be applied is broadly similar to Hong Kong insolvency law, or the specific relief which is sought is available under Hong Kong law. However, Judge Harris, who gave the judgments for the Hong Kong case, also emphasised the importance of incorporating modified universalism principles into Hong Kong legislation regulating cross-border insolvency, saying “it is highly desirable that the new legislation includes provisions dealing expressly with cross-border insolvency.....”<sup>105</sup> Failure to do so would be a regrettable missed opportunity to ensure that Hong Kong’s insolvency legislation is consistent with the principles of modified universalism and the needs of international commerce.<sup>106</sup> Moreover, the judge also said that without legislation, it probably raises concerns and indicates that Hong Kong courts would take the restrictive view of the extent to which they should assist foreign liquidators, which is not consistent with the traditional Hong Kong courts' attitude.<sup>107</sup>

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<sup>104</sup> *The Joint Official Liquidators of A Company v B and Another* [2014] 4 HKLRD 374.

<sup>105</sup> *The Joint Official Liquidators of A Company v B and Another* [2014] 4 HKLRD 374, para 19 per Harris J.

<sup>106</sup> *ibid.*

<sup>107</sup> *ibid.*

## 5.5 Conclusion

Hong Kong has a more advanced and well-structured insolvency system because of the historical influences from the UK, and the local legislation and common law system supplement each other. For solving cross-border insolvency issues, the Hong Kong courts have proved their willingness to cooperate with foreign proceedings in practice. Hence, there is good legal and practical foundation to adopt the UNCITRAL Model Law in Hong Kong. Although it remains unresolved whether Hong Kong would adopt the law or not, it is not difficult to say that Hong Kong judges have already incorporated the spirits of modified universalism into their common law approaches. In deciding the jurisdiction issue related to off-shore companies, one crucial factor that the court considered was that the offshore registered company's assets and commercial activities were all located in Hong Kong, and this is the same consideration behind the concept "COMI". Such a development was necessary to make sure Hong Kong's insolvency legal system is consistent with the international mainstream. Hong Kong now is the only major common law jurisdiction that has not adopted the UNCITRAL Model Law, after Singapore's implementation in 2017. It could be expected that the lawmakers in Hong Kong will focus more attention on the UNCITRAL Model Law in the coming years.

## **Chapter 6 Cross-border Insolvency Matters between Mainland China and Hong Kong**

Chapter 5 was focused on the cross-border insolvency issues between Hong Kong and foreign countries, and how the common law principles and local legislation could provide a relatively clear cross-border insolvency system. Comparatively speaking, the insolvency cases between mainland China and Hong Kong can be more complicated because of the political arrangement. After the political change in Hong Kong, the central government and Hong Kong government signed an economic agreement, the Closer Economic Partnership Arrangement (CEPA), in order to facilitate bilateral trades between the two jurisdictions. The agreement is the economic basis that capitalist and socialist economics can coexist within the same sovereign state, but operate within separate legal and commercial frameworks. However, the development of the legal arrangement between the two separate judicial jurisdictions has not closely followed the economic agreement. Especially the judicial recognition, which is central to the enforceability of any judicial judgment made in the court of a counterparty jurisdiction, is still an unsolved problem between China and Hong Kong. This chapter will analyse the general difficulties and complexities of cross-border insolvency matters between the mainland and Hong Kong, and try to find possible solutions.

Part 1 argues that it is necessary to have a separate law for mainland and Hong Kong cross-border insolvency matters because of the political arrangement and close economic relationship; the tradition of the Chinese government's interference in legal proceedings is another main reason, and has to be considered in the specialised regulation. Part 2 explores the development of judicial recognition and cooperation between the two regions, and the application of an interregional judgment recognition arrangement. Part 3 discusses practical concerns that exist under the current judicial recognition regime and their influences on insolvency cases. Part 4 investigates whether the UNCITRAL Model Law's principles could be useful in developing an interregional solution within China. Part 5 summarises the recommendations for the cross-border insolvency law between the two jurisdictions.

## 6.1 Insolvency Issues between Mainland China and Hong Kong

### 6.1.1 The Necessity for a Separate Law

The cross-border insolvency issues may arise between the mainland and Hong Kong in situations like one court in Hong Kong seeking cooperation from their counterparty courts in the mainland in order to validate a claim raised by a creditor in Hong Kong against an insolvent debtor in the mainland, or a party from Hong Kong maybe wanting to seek judicial recognition from a mainland court in order to enforce a judgment made by a Hong Kong court. Similar issues with another country would be governed by private international laws and laws for cases involving foreign elements. Since the mainland and Hong Kong are two totally different jurisdictions within one country, such an international approach would no longer be appropriate.<sup>1</sup> Hence, it is necessary to have a specially formulated legal tool to govern the interregional insolvency issues within China, and such necessity can be justified by political, economic and legal considerations.

Politically, "one country, two systems", which allows two different political systems to co-exist within one country, is the foundation of the relationship between the mainland and Hong Kong.<sup>2</sup> So, the two jurisdictions are relatively independent but closely connected at the same time. The policy has created a unique political relationship between the two areas. According to the Basic Law, the central government in Beijing is the sole authority for both the mainland and its SARs, and the degree of autonomy of Hong Kong is higher than a state under a federal regime like in the US.<sup>3</sup> Consequently, the unique political arrangement inevitably causes legal issues, which requires both

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<sup>1</sup> Lingling Liang and Yuying Zeng, 'The Difficulties and Cooperation of Cross-border Insolvency Matter Between Mainland and Hong Kong' (2015) 24 *Journal of Mudanjiang University* 22.

<sup>2</sup> *ibid.*

<sup>3</sup> The high degree is mainly about the judicial power (Article 19 of the Basic Law), and it is supported by the establishment of the Court of Final Appeal (Article 81 of the Basic Law). Further discussion: Wang Shuwen, *Introduction to the Hong Kong SAR Basic Law* (Central Committee of the CCP Party School Press, 1997).

governments to work together closely to find solutions, step by step.<sup>4</sup> Since economic development is a vital part of all countries' political tasks, it is inevitable that solid and effective policies for all the business-related matters between two jurisdictions should be built.<sup>5</sup>

Economically, the connection between the mainland and Hong Kong has been very interactive since the handover in 1997, especially after the passing of the Closer Economic Partnership Arrangement (CEPA).<sup>6</sup> The arrangement aims to promote economic cooperation, and strengthen the trade relationship in goods and services between the two places. One substantial content of the agreement includes applying zero import tariffs to all imports from Hong Kong, and liberalising trade-in services between the two areas.<sup>7</sup> Furthermore, the agreement also includes an agreement to facilitate investment in various areas, including transparency in legal regulations. In order to solve new trading problems in practice, the supplementary agreements of CEPA will be signed annually between the mainland and SAR.<sup>8</sup> CEPA has its own dispute settlement system, which is called the Joint Steering Committee. However, since the agreement is experimental and developing, this system is not mature enough to solve all the inter-regional commercial conflict.<sup>9</sup> The current way that the Committee works is based on cooperative discussion and consultation between representatives or officials from both areas.<sup>10</sup> Therefore, the success of CEPA and the close economic partnership requires an efficient and predictable problem-solving mechanism when businesses involving parties from both places meet difficulties.

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<sup>4</sup> Shanbin Huang, Xu Zhang and Wenzhi Wen, 'The Analysis about the Building the Cooperation System of Cross-Border Insolvency Between Mainland and Hong Kong' (2012) 33 (1) *Journal of Kashgar Teachers College* 31.

<sup>5</sup> *ibid*, 32.

<sup>6</sup> Mainland and Hong Kong Closer Economic Partnership Arrangement (hereafter as CEPA) (2003) (HK).

<sup>7</sup> *ibid*, Introduction.

<sup>8</sup> Since 2003, ten supplementary agreements have been signed, please see the latest development: <[https://www.tid.gov.hk/english/cepa/further\\_liberal.html](https://www.tid.gov.hk/english/cepa/further_liberal.html)>

<sup>9</sup> CEPA, Article 19.

<sup>10</sup> CEPA, Article 19 (5).

Legally, the current legal cooperation agreement in commercial matters between two areas does not cover insolvency cases, so solutions have to be solved by the local laws of each region. The insolvency law systems in the two jurisdictions are not clear and effective enough to solve the interregional insolvency issues. Most of the relevant provisions relating to cross-border insolvency issues have specific application for “foreign” insolvency proceedings, and using such provisions is not consistent with the “one country” principle. With the increasing number of insolvency cases between the two regions, lack of a clear legal instrument may lead to more serious issues, such as some parties may take advantage of the differences to avoid legal responsibilities, or start proceedings in both jurisdictions for extra payments.<sup>11</sup> Therefore, a clear regulation is needed to clarify those legal uncertainties and provide guidance for parties from both the mainland and Hong Kong.

### **6.1.2 Local Protectionism and Cautious Attitudes towards Insolvency**

As mentioned in the previous chapters, government involvement in insolvency proceedings is not unusual, and this cautious tradition has caused serious issues between the mainland and Hong Kong. Social stability and safety is a main factor that concerns the local government. If there are a number of individual legal actions, such as employment disputes or individual creditors proceedings, the local government usually steps in and solves the case quickly and locally, which means it distributes local assets to local creditors rapidly, and ignores the demands of cross-border matters.<sup>12</sup> Such a solution is a very typically Chinese legal solution, and usually it would end up sacrificing creditors' or debtors' interests.

Government involvement in insolvency cases may lead to local protectionism, especially at the provincial level. *Ocean Grand Holdings Limited v Ocean Grand Aluminum Industries (San Shui) Ltd*,<sup>13</sup> which was a case involving both

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<sup>11</sup> Shanbin Huang, Xu Zhang and Wenzhi Wen (n 4) 31.

<sup>12</sup> *ibid.*

<sup>13</sup> *Ocean Grand Holdings Limited v Ocean Grand Aluminum Industrial (San Shui) Ltd*, Foshan Intermediate Court, Fu Lingxiao, ‘Analysis of the Accepted Conditions of the Creditors’ Application of the Bankruptcy of the Debtor’ 30 March 2010.

the mainland and Hong Kong, would be a good example to demonstrate local protectionism.

Ocean Grand Holdings Limited (Ocean Grand) was incorporated in Bermuda on 15 May 1997, and was registered in Hong Kong on 8 July 1997. It is a holding company whose subsidiaries were mainly located in Nanhai and Zhuhai in the mainland, and in Hong Kong. Ocean Grand Aluminium Industrial (San Shui) Ltd (OG San Shui) is one of the subsidiaries in the mainland. On 24 July 2006, Ocean Grand presented a petition for its own winding-up in Hong Kong and in Bermuda. Provisional liquidators were appointed on the same day in Hong Kong and on the following day in Bermuda. Before the application, it had been reported that a total sum of \$840 million worth of funds in mainland subsidiaries had disappeared.

To make further investigation and reduce the loss, the provisional liquidator appointed by the Hong Kong court went to the mainland, but he did not get any cooperation from local banks or courts. So the liquidator on behalf of Ocean Grand filed a bankruptcy application to the Foshan Intermediate Court against OG San Shui on the grounds that the company was unable to pay debts as they fell due and was insolvent. The application was rejected by the Chinese court because it held that a clear debtor-creditor relationship between the claimant and the defendant, which was the prerequisite of the courts to accept the application, could not be verified.

At the same time, because of the insolvency news of Ocean Grand in Hong Kong, the local creditors in the mainland, including banks, suppliers and employees, filed a large number of individual lawsuits against the subsidiaries of Ocean Grand in the mainland, including the OG San Shui, for repayment of their debts. The local court then seized and froze the assets of those subsidiaries, and those assets were sold off by auction under the supervision of the local court.

The case was closed by the local court because of a series of individual debt lawsuits instead of the insolvency proceeding. The reason that the local courts chose this way is probably due to a large amount of employment salary

payment cases being filed. Once again, the Chinese court focused on the protection of local creditors and refused to cooperate with the Hong Kong liquidator. It has been said by the Hong Kong liquidator that it is easier to recover assets in a foreign country than in the mainland, even though Hong Kong has returned to China. Therefore, if Hong Kong creditors want to participate in the distribution in the mainland, they might have to file debt lawsuits in mainland courts too. In this case, it was lucky that the remaining assets of the subsidiaries were enough to cover the claims of local creditors, even though a large amount of the fund had been transferred away. If there were not enough assets, the mainland creditors would probably have had to have gone to Hong Kong to file lawsuits. Furthermore, without any cross-border insolvency convergence, the case could be a bad example to other companies, encouraging debtors to transfer funds between the two regions in order to avoid their debts.<sup>14</sup> As mentioned above, it is very common for a company to hold assets both in Hong Kong and the mainland, so without a better solution, the process will be expensive and time-consuming when solving inter-regional insolvency cases between two jurisdictions.

Local protectionism, which means that Chinese courts are likely to grant favourable judgments to local enterprises at the expense of foreign parties, is one issue that Chinese courts have always been criticised for.<sup>15</sup> Professor Huang explains such issue as: "Local protectionism means that in dealing with litigation, courts are often biased in favour of parties from their own region. This problem is well-known and deeply-rooted in China due to the lack of the courts' independence — the local courts are dependent on the local government in terms of funding, and personnel decisions relating to the local judiciary are also in the hands of the local government."<sup>16</sup> Local protectionism

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<sup>14</sup> Xinyi Gong, 'When Hong Kong Becomes SAR, Is the Mainland Ready? Problems of Judgments Recognition in Cross-border Insolvency Matters' (2011) 20 *International Insolvency Review* 57.

<sup>15</sup> Emily Lee, 'Problems of Judicial Recognition and Enforcement in Cross-Border Insolvency Matters between Hong Kong and Mainland China' (2015) *American Journal of Comparative Law* 439.

<sup>16</sup> Robin Hui Huang, 'Private Enforcement of Securities Law in China: a Ten-year Retrospective and Empirical Assessment' (2013) 61 *Am. J. Comp. L* 757,795.

has a negative influence on justice, and thus serves as a reason that prevents parties from choosing to use mainland Chinese courts to hear their cases. The fact that mainland Chinese courts are funded by their local government enables the local government to interfere with the judicial process by pressuring or instructing the court to make rulings in favour of local businesses that contribute to the local economy, such as by paying taxes and providing jobs.<sup>17</sup> A further reason is that the local economic performance and GDP will be part of local officials' political assets, which will influence their opportunity for promotion.<sup>18</sup> Because of a lack of an appropriate understanding of the concept of insolvency, many local officials would think the word "insolvency" or "bankruptcy" equals liquidation.<sup>19</sup> So, insolvency of local businesses would have negative influences on their political achievements. Consequently, local officials are prepared to use their administrative powers to intervene in insolvency cases.

To sum up, local government are currently involved in insolvency cases, and local protectism will continue to happen in the foreseeable future. Even though the government and the Supreme Court have issued guidance suggesting that legal proceedings should be the main method of solving insolvent businesses and reducing the role of local government,<sup>20</sup> the situation will not change significantly if the insolvent companies are related to local economic interests and political performance. For the cases relating to Hong Kong, it could be another reason that the central government and Hong Kong government should draft an interregional insolvency regulation together. If a clear regulation with detailed guidance could provide a solution that will help all the

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<sup>17</sup> Xiaoping Jin, 'The Study on the Role of Local Government in Corporate Insolvency' (PhD Thesis, Southwest University of Political Science and Law 2015).

<sup>18</sup> Xinxin Wang and Yangguang Xu, 'The difficulty and Solution of Chinese Insolvency Law: the Reason of the Decrease of the Number of Insolvency Cases' (Research Report of China Insolvency Forum, 2013) <<http://www.yunqingsuan.com/news/detail/7702/page/2>> accessed 20 September 2017.

<sup>19</sup> *ibid.*

<sup>20</sup> Opinions of the Supreme People's Court on Several Issues Concerning Correctly Trying Enterprise Bankruptcy Cases to Provide Judicial Protection for Maintaining the Order of Market Economy, The Supreme People's Court [2009] Judicial Interpretation No.36.

parties to benefit, it will help the local government avoid the kind of chaotic situation as happened in the *Ocean Grand* case, and political interference could be reduced.

### **6.1.3 The Basic Legal Issues**

This part is to discuss the difficulties when solving cross-border insolvency questions between the mainland and Hong Kong based on the three basic issues: jurisdiction, choice of law and recognition and enforcement.

#### **Jurisdiction and Choice of Law**

When facing an insolvency case, the courts in both jurisdictions will decide the jurisdiction issue based on their local laws; since both the mainland and Hong Kong have broad jurisdiction rules, this may lead to some conflict. There is a common argument suggesting that HK-mainland insolvency typically involves companies whose assets and/or investors were in both jurisdictions, with investors located in Hong Kong, and with the joint venture (JV) investment located in the mainland.<sup>21</sup> Understandably, the mainland Chinese courts will have jurisdiction because China is the JV's place of incorporation, and is also the location of the JV's assets. Yet the Hong Kong courts can also claim jurisdiction, if and when the JV's investors who reside in Hong Kong commence insolvency proceedings in the Hong Kong courts. Furthermore, the conditions to be considered for the purpose of jurisdictions can be different in both places, which would raise the issue of whether the proceeding is qualified to be recognised in the other jurisdiction.<sup>22</sup> The insolvency proceedings can become even more complicated if, in the establishment of the business, a Hong Kong investor incorporated a company in a tax haven jurisdiction, and operated most of the businesses in the mainland. As we have discussed in the last two chapters, both jurisdictions could claim jurisdiction for such a case based on their relevant laws or common law principles. Although the broad principles for jurisdiction under the two places share similarities and

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<sup>21</sup> Emily Lee, 'Comparing Hong Kong and Chinese Insolvency Laws and Their Cross-Border Complexities' (2015) 9 (2) *The Journal of Comparative Law* 259.

<sup>22</sup> Shanbin Huang, Xu Zhang and Wenzhi Wen (n 4), 35.

differences, it is difficult to have a unified rule as those rules under Hong Kong laws have been developed based on common law, and those under Chinese laws have been separated under bankruptcy law and Civil Procedural Law.<sup>23</sup>

The issue for the choice of law rules could not be more uncertain. For both the mainland and Hong Kong, jurisdiction and choice of law rules are closely connected together.<sup>24</sup> In the mainland, the applicable law will be decided based on the jurisdiction, so Chinese law will be automatically applied if Chinese courts have jurisdiction. The Hong Kong Courts would be more open about applying foreign law in certain cases, but the general rule is to apply the local law.

### **Recognition and Enforcement**

Since there is no direct way of seeking recognition of a cross-border insolvency judgment between the mainland and Hong Kong, the insolvency practitioners have to find a detour. Article 5 of the Enterprise Bankruptcy Law 2006 of China provides some basic frameworks for recognition, such as reciprocity without violation of China's basic principles of its laws, sovereignty, security and public interests.<sup>25</sup> Although Article 5 is still too general and impractical, it provides legal justification for recognising foreign insolvency proceedings. Further, Hong Kong courts have always applied open and willing attitudes for providing judicial assistance to foreign insolvency proceedings. Therefore, compared with the issue of jurisdiction, it would be easier to find common ground on the issue of recognising proceedings between the mainland and Hong Kong. The approach focusing on recognition and cooperation can be traced back to the development process of the UNCITRAL Model Law. Therefore, this could be a starting point for solving the mainland China and Hong Kong problem as well.

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<sup>23</sup> Ling Zhang, 'The Research on the Trend of Cross-Border Insolvency Cooperation' (2003) 21 (4) *Tribune of Political Science and Law* 177.

<sup>24</sup> Faye Fang and Fei Wang, *Internet Jurisdiction and Choice of Law: Legal Practices in the EU, US, and China* (Cambridge University Press, 2001) 184.

<sup>25</sup> Article 5, Enterprise Bankruptcy Law of PRC 2006 (China).

Furthermore, both jurisdictions have already realised that judgment recognition and assistance is important for the “one country, two systems” relationship. The Arrangement of Mutual Recognition and Enforcement of Judgments in Civil and Commercial Matters between Mainland China and Hong Kong was passed in 2006. The arrangement has provided a good start and valuable guidance for judicial cooperation issues between the two regions. Therefore, it is worth reviewing the general development of the judicial recognition area between the mainland and Hong Kong, and seeing how the interregional insolvency issue would fit into this area.

## **6.2 The Development of Judicial Recognition between Mainland and Hong Kong**

### **6.2.1 Judicial Difficulty after 1997**

The problem of judicial recognition between Hong Kong and China has also evolved through different historical and political stages.

Before 1997, Hong Kong was a British colony, so the judicial recognition between Hong Kong and China must be based on relevant international conventions. The first is the Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958 (the New York Convention), which provides common legislative standards for the recognition of arbitration agreements, stating that foreign and non-domestic arbitral awards cannot be discriminated against and thus can be capable of entitling court recognition and enforcement in the same way as domestic awards.<sup>26</sup> The UK government extended the Convention to Hong Kong in 1975, but the judicial assistance in the area of arbitration between China and Hong Kong did not start until 1987, when the Chinese government ratified the New York Convention.<sup>27</sup> Another is the

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<sup>26</sup> Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York, 1958) (the "New York Convention") <[http://www.uncitral.org/uncitral/en/uncitral\\_texts/arbitration/NYConvention.html](http://www.uncitral.org/uncitral/en/uncitral_texts/arbitration/NYConvention.html)>.

<sup>27</sup> The New York Convention introduced by the official document, *the Decision of the Standing Committee of the National People's Congress on China Joining the*

Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil and Commercial Matters of 1965, known as the Hague Convention.<sup>28</sup> The purpose of the Convention is to improve the organisation of mutual judicial assistance in cases of civil or commercial matters for judicial or extrajudicial documents to be served abroad.<sup>29</sup> The UK government also extended it to Hong Kong in 1970 and China ratified it in 1991. It should be noticed that although Article 153 of Basic Law states the international agreements implemented in Hong Kong may continue to be effective in the HKSAR after the handover, the international conventions cannot be applied between China and Hong Kong since the application of international conventions may only be used among states as independent subjects of the international community.

After the handover, Article 5 of the Basic Law of Hong Kong provides that the socialist system and policies in China will not be practiced in Hong Kong following the return of Chinese sovereignty over Hong Kong; instead, Hong Kong's capitalist system will remain unchanged for 50 years under the proviso of the "one country, two systems" principle.<sup>30</sup> However, although the political arrangement was relatively clear, there are several legal issues about the relationship between the mainland and its special regions caused by the political change which have been calling for clarification for many years.<sup>31</sup> Judicial assistance is one of them.

The Chinese government did not introduce any regulation or agreement on

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*Convention on the Recognition and Enforcement of Foreign Awards*, published in 1986, and the Convention came into force on April 1987.

<sup>28</sup> Convention on the Service Abroad of Judicial and Extrajudicial Documents in Civil or Commercial Matters. <<https://www.hcch.net/en/instruments/conventions/full-text/?cid=17>>.

<sup>29</sup> Ying Liu and Guomin Li, *Private International Law: Materials* (CITIC Publishing House, 2004) 422.

<sup>30</sup> Article 5 "The socialist system and policies shall not be practiced in the Hong Kong Special Administrative Region, and the previous capitalist system and way of life shall remain unchanged for 50 years." The Basic Law of Hong Kong.

<sup>31</sup> Zhenshun Cai and Yunjun Yang, 'The Discussion about Judgment Recognition and Enforcement on Civil and Commercial Matters between Hong Kong and Mainland China' (2008) 19 (5) *Journal of Guangdong University of Foreign Studies* 23.

the matter of judicial recognition and assistance under the “one country, two systems” regime, and the mainland’s courts treated cases from special administrative regions as foreign matters. Article 5 of judicial interpretation, issued in 2002 by the Supreme People's Court and called "Provisions Concerning the Jurisdiction Problems of Foreign-related Civil and Commercial Cases", states the jurisdiction of civil and commercial cases involving HKSAR, Macao SAR, and Taiwan shall be solved by referring to the Provision.<sup>32</sup> Apparently, treating legal issues from Hong Kong and Macao as foreign matters is not something the central government intended to do. On the other hand, from the Hong Kong side, the Basic Law only contains one ambiguous article about judicial assistance with the mainland; it states “The Hong Kong Special Administration Region, may, through consultations and in accordance with law, maintain juridical relations with the judicial organs of the country, and they may render assistance to each other”, which does not address any specific issue for judgment recognition between the mainland and Hong Kong.<sup>33</sup> This has led to the situation where the only option mainland judges have is to apply the laws for foreign matters when they are facing judicial matters from Hong Kong. Moreover, the law did not provide any practical guidance about the procedure for seeking judicial assistance in the mainland courts. Therefore, it seems that the political arrangement caused a legal gap in the area of judicial assistance between the mainland and its special administrative regions.

The close economic connection between the mainland and Hong Kong also requires further clarification regarding legal difficulty.<sup>34</sup> It has been said the close economic relationship would inevitably cause disputes between participants from both regions.<sup>35</sup> If Hong Kong courts have jurisdiction over the disputes, the parties prefer to choose Hong Kong courts rather than the

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<sup>32</sup> Provisions Concerning the Jurisdiction Problems of Foreign-related Civil and Commercial Cases, The Supreme People’s Court [2002] Judicial Interpretation No. 5

<sup>33</sup> Article 95, the Basic Law of Hong Kong (HK).

<sup>34</sup> Qiangjiang Kong, ‘Enforcement of Hong Kong SAR court Judgment in the People’s Republic of China’ (2000) 49 (4) *International & Comparative Law Quarterly* 867.

<sup>35</sup> *ibid.*

mainland courts because the fact is that the legal system of Hong Kong is more developed and predictable than the relevant laws of the mainland. If some properties of a case are located on the mainland, judgment recognition and enforcement should be sought in courts of the mainland. Without a clear law for such matters, it would not only harm the predictability of commercial law in Hong Kong and thus be detrimental to its judicial system. This would damage Hong Kong's position as an international economic centre, which is important for the economic development of both Hong Kong itself and the mainland.<sup>36</sup>

## **6.2.2 The General Rules for Recognition before the Arrangement**

### *The Mainland China*

As has been mentioned in the last chapter, the general rule for recognition of foreign judgments in the mainland is based on treaty or agreement and the principle of reciprocity. As for the recognition and enforcement of Hong Kong judgments in cases beyond the scope of the arrangement, the general rule will be applied. In practice, it could be very difficult to recognise or enforce judgments based on those two requirements.

Recognition cases from special administration regions have always been difficult questions for the mainland courts. There are two opinions relating to this issue from previous judgments. The first one treats those special regions as foreign jurisdictions, so their judgments are not recognisable in the mainland-based Article 268 of Civil Procedure Law requiring the existence of treaties or reciprocity. Since no relevant agreements exist between Hong Kong and China, a Hong Kong judgment will not be recognised in the mainland. A case decided by an intermediate people's court in Fujian province applied this opinion.<sup>37</sup> The Hong Kong company in this case mortgaged a

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<sup>36</sup> *ibid*, see also Zhihong Yu, 'The Analysis of Judgment Recognition and Enforcement on Civil and Commercial Matter between Hong Kong and Mainland China' (2015) *Jinan Journal* <<http://article.chinalawinfo.com/ArticleFullText.aspx?ArticleId=94958>> accessed 12 June 2017.

<sup>37</sup> The Case of Investment Co of Hong Kong to Recognise a Hong Kong Civil

piece of real estate located in the jurisdiction of the Quanzhou Intermediate People's Court and could not pay the loan on time. The creditor sued the company in the Hong Kong high court and received a favourable judgment. Then the creditor applied to the Intermediate Court seeking enforcement of the judgment on collateral and other properties located on the mainland. The court decided to refuse the recognition and enforcement because there was no recognition agreement and reciprocity between the two jurisdictions based on Article 268 of Civil Procedure Law.

The second opinion holds that, because Hong Kong has become part of China, it is improper to treat its judgments as foreign judgments.<sup>38</sup> According to this opinion, in a recognition case, the requested Xiamen court held that under Article 95 of the Basic Law, interregional judgment recognition should be carried out after the competent authorities in the two regions had reached an agreement. Since no such agreement existed, the court dismissed the application and suggested the judgment creditors bring an action of contractual dispute against the debtor.<sup>39</sup>

Nevertheless, the two opinions reach the same result in most of the cases: Hong Kong judgments cannot be recognised, so the parties have to re-litigate their disputes in the mainland, which would be time and money-consuming, and may also lead to inconsistent judgment.<sup>40</sup> Two factors might explain why the mainland courts have been conservative in dealing with recognition issue relating to special administrative regions. Firstly, the mainland courts do not have broad discretion. The courts appointed to hear the recognition application will be intermediate courts, which are subordinate to the Supreme People's Court and High People's Courts, so they usually adopt conservative

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Judgment (Quanzhou Interm People's Ct, 26 November 2001) <[www.lawyee.net](http://www.lawyee.net)> (accessed 20 November 2017). See also Jie Huang, 'Interregional Recognition and Enforcement of Civil and Commercial Judgments: Lessons for China from US and EU Laws' (2010) 6 (1) *Journal of International Private Law* 109, 125.

<sup>38</sup> Xinyi Gong (n 14) 58-60.

<sup>39</sup> The Case of Enforcing the Judgment of Li Deng Li Development Co and Fu Fua Enterprise (Xiamen Inter People's Court, 23 February 2000).

<sup>40</sup> Qiangjiang Kong (n 34) 870.

solutions until they receive new instructions from higher level courts. Another reason would be that there is no reciprocity relationship or agreement between the mainland and Hong Kong.

As for the reciprocity, apart from some old divorce cases, the mainland courts have never recognised and enforced foreign judgments under the principle of reciprocity.<sup>41</sup> It has been suggested that China adopts a passive reciprocity approach, which means the mainland courts hesitate to take the initiative when other regions do not recognise and enforce the mainland judgments under this principle first. Furthermore, the definition of the principle of reciprocity and how to apply it under Chinese law is unclear, which would also discourage the mainland judges.<sup>42</sup>

### Hong Kong

In Hong Kong, a foreign judgment may be recognised or enforced either by statutes or common law principles. The coming into effect of the Arrangement in August 2008 resulted in the enactment of the Mainland Judgments (Reciprocal Enforcement) Ordinance, which is now part of Hong Kong law.<sup>43</sup> Other than that, Hong Kong has the Foreign Judgments (Reciprocal Enforcement) Ordinance, which holds that a final and conclusive judgment made by a foreign superior court may be recognised and enforced in Hong Kong on a reciprocal basis, subject to that foreign judgment being registered with the High Court of Hong Kong.<sup>44</sup> Originally, the Foreign Judgment Ordinance closely followed the Foreign Judgments Act 1933 (UK), and it was essentially an intra-Commonwealth scheme for reciprocity enforcement.<sup>45</sup> The non-commonwealth countries that the law also applied to are those that the UK already had judgment recognition treaties with, such as Belgium and

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<sup>41</sup> Qingjiang Kong and Minfei Hu, 'The Chinese Practice of Private International Law' (2002) 3 (2) *Melbourne Journal of International Law* 414.

<sup>42</sup> *ibid.*

<sup>43</sup> Mainland Judgments (Reciprocal Enforcement) Ordinance (Cap. 597), Hong Kong.

<sup>44</sup> Foreign Judgments (Reciprocal Enforcement) Ordinance (Cap. 319), Hong Kong.

<sup>45</sup> *ibid.*, "To make provision for the enforcement in the Colony of Hong Kong of judgments given in other parts of the Commonwealth and foreign countries which afford reciprocal treatment to judgments given in the Colony of Hong Kong".

France. As a result, all the other jurisdictions' judgments, including those with mainland China, are recognised and enforced in Hong Kong based on the common law system. Under the Foreign Judgment Ordinance, only foreign judgments that concern monetary civil matters can be considered to be enforced, and judgments have to be "final and conclusive".<sup>46</sup> Same requirements can also be found under the mainland/Hong Kong Arrangement.

For insolvency cases, as discussed in the last chapter, there are no statutory provisions that regulate recognition or cooperation relating to foreign insolvency proceedings. Consequently, the related principles are to be found based on common law. Generally speaking, the Hong Kong courts would recognise a foreign insolvency judgment made in the place of the company's incorporation; however, this is not the only criteria for recognition. If the foreign court is not in the place of incorporation, other situations to be considered include that the company conducts business within that jurisdiction, that the company submits to the insolvency jurisdiction in the foreign jurisdiction, or that an insolvency proceeding is unlikely to take place in the jurisdiction in which the company is incorporated.

For mainland insolvency cases seeking recognition, the Hong Kong court has adopted an open-minded approach, on a case by case basis. Such an approach can be shown in the famous case, *CCIC v Guangdong International Trust & Investment Corp (GITIC)* [2005] 2 HKC 589, which involved the issue of whether the bankruptcy of GITIC in the mainland should be recognised in Hong Kong.<sup>47</sup>

GITIC was incorporated in the mainland and registered in Hong Kong under Part XI of the Companies Ordinance as an overseas company. Guangdong International Trust & Investment Corporation Hong Kong (Holdings) Limited ("GITIC HK") was incorporated in Hong Kong as a wholly-owned subsidiary of GITIC. The case involved a "garnishee order" which is a Court order requiring

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<sup>46</sup> *ibid*, Section 2, Section 3 (2) a.

<sup>47</sup> *CCIC v Guangdong International Trust & Investment Corp (GITIC)* [2005] 2 HKC 589.

a third party owing money to the judgment debtor to pay his debt directly to the judgment creditor. CCIC Finance, the judgment creditor, had obtained (i) a Hong Kong High Court judgment by default against GITIC, the judgment debtor, and (ii) a garnishee order nisi against GITIC HK. CCIC Finance applied to make the garnishee order absolute, which would require GITIC HK to pay its debt directly to CCIC Finance and not to GITIC.

Deputy Judge Gill acknowledged that it is a rule of international law that where there is already pending a process of universal distribution of a bankrupt's effects in a foreign jurisdiction, the local court should not allow an action to be taken within its jurisdiction which would interfere with that process. It was thus necessary to examine the nature of the winding-up of GITIC in the PRC, and in particular whether the 1986 Bankruptcy Law was intended to, or purported to, apply to GITIC's extraterritorial assets. It was held that the concept of comity of nations alone is not a reason to reject the claim of a litigant where the merits of his claim were such that it should otherwise be granted. However, where a foreign jurisdiction actively and openly pursues a liquidation in which it says that it intends to treat all creditors, domestic and foreign, on the same basis, and then it clearly does so, it is not for the Hong Kong Court to interfere with that process.

This was the first significant case to contribute to the debate on cross-border insolvency matters between China and Hong Kong, and it was also the first case where the Hong Kong court recognised the mainland insolvency proceeding. Since the case happened before the introduction of the new corporate bankruptcy law, one of the core issues was about whether the old Chinese bankruptcy law had extraterritorial effects. Arguably, the previous Chinese bankruptcy law did not have much effect since it was designed specifically to regulate the insolvency proceedings of state-owned enterprises, the issue of the extraterritorial effect being solved by the new bankruptcy law in 2006.<sup>48</sup> Nevertheless, the court held that the proceeding should be

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<sup>48</sup> Jingxia Shi, 'Recent Developments in Chinese Cross-Border Insolvencies', <[https://www.iiiglobal.org/sites/default/files/2-\\_060710shi-3.pdf](https://www.iiiglobal.org/sites/default/files/2-_060710shi-3.pdf)> accessed 12 Junly 2017; see also, Xianchu Zhang and Charles Booth, Beijing's Initiative on Cross-

recognised based on comity, taking into consideration the fact that the mainland proceeding was pursuing a universal collection and distribution of whole assets of the debtor, and all the creditors were at the same ranking.<sup>49</sup> After this case, it probably would be too optimistic to say it set an example for future mainland insolvency cases to be recognised in Hong Kong. However, the fact that the court considered all the relevant facts and granted the recognition illustrates an open attitude toward cross-border insolvency issues with the mainland.

### **6.2.3 The Mainland and Hong Kong Arrangement and Its Application**

In order to solve the conflict of laws cases involving the Hong Kong courts and the provincial courts in China, the Arrangement of Mutual Recognition and Enforcement of Judgments in Civil and Commercial Matters between Mainland China and Hong Kong SAR was signed in 2006.<sup>50</sup> The arrangement was concluded in 2006 and came into effect after the Supreme People's Court of mainland China promulgated a judicial interpretation, and Hong Kong passed the relevant legislation in 2008. As suggested by its name, the Arrangement only applies to civil and commercial matters, which need an enforceable final judicial judgment requiring payment of money in civil or commercial cases pursuant to a choice of court agreement in writing, rendered by a people's court of the mainland or a court of Hong Kong.<sup>51</sup> Accordingly, this arrangement has been criticised by legal scholars and professionals regarding its restricted scope in practice.<sup>52</sup>

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Border Insolvency: Reflections on a Recent Visit of Hong Kong Professionals to Beijing (2002) Conference paper.

<sup>49</sup> *ibid*,

<sup>50</sup> The official name of the document: *Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region Pursuant to Choice of Court Agreements between Parties Concerned*.

<sup>51</sup> Article 1 and 2, The Supreme People's Court's Arrangement between the Mainland and the HKSAR on Reciprocal Recognition and Enforcement of the Decisions of Civil and Commercial Cases under Consensual Jurisdiction.

<sup>52</sup> Guangjian Tu, 'Recognition and Enforcement of Mainland China's Civil and Commercial Judgments in Hong Kong – An Update' (2017) 25 (2) *Asia Pacific Law*

Nevertheless, this Arrangement is a milestone for interregional judgment recognition between the mainland and Hong Kong.<sup>53</sup> It was a significant step by the authorities in trying to facilitate legal conflicts between the mainland and its SARs; it also provides valuable guidance for future judicial assistance in civil or commercial cases between China and other common law jurisdictions.<sup>54</sup> Furthermore, it should be acknowledged that passing such an interregional arrangement involved a certain degree of political consideration. For the mainland, it would solve the inconsistency in that the mainland courts are treating Hong Kong cases as foreign matters, while the central government keeps emphasising all Hong Kong matters are domestic affairs; in this respect, it could be considered a symbol of respecting the “one country, two systems” arrangement. For Hong Kong government interest, it is necessary to have a legal document to safeguard the autonomy provided by the Basic Law and to ensure its judicial independence in other jurisdictions within the same country.<sup>55</sup> These political concerns and legal differences between the two jurisdictions perhaps were the main reasons that the negotiation and drafting took more than 6 years, and the final version of the arrangement has a restrictive scope. There are two issues in the final version which reflect its limitations.

#### **A. Monetary Judgment in Civil and Commercial Matters**

One requirement is that only monetary judgments in civil and commercial monetary disputes will be covered by the Arrangement. According to the explanation from the Hong Kong authority, the Arrangement excludes any employment contracts and contracts to which a natural person is acting for

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*Review 190*; see also Emily Lee, ‘Legal Pluralism, Institutionalism, and Judicial Recognition of Hong Kong-China Cross-Border Insolvency Judgments’ (2015) 45 (1) *Hong Kong Law Journal* 331.

<sup>53</sup> *ibid*, see also Emily Lee, ‘Problems of Judicial Recognition and Enforcement in Cross-Border Insolvency Matters between Hong Kong and Mainland China’ (2015) 63 (2) *American Journal of Comparative Law* 439.

<sup>54</sup> Xiachu Zhang and Philip Smart, ‘Development of Regional Conflict of Laws: On the Arrangement of Mutual Recognition and Enforcement of Judgments in Civil and Commercial Matters between Mainland China and Hong Kong SAR’ (2006) 36 (3) *Hong Kong Law Journal* 553.

<sup>55</sup> *ibid*.

personal consumption, family, or other non-commercial purposes.<sup>56</sup> So judgments related to matters like marriage, bankruptcy, winding-up and consumer disputes are all excluded. Such limited scope has been criticised, especially compared with the situation in Macao, which has a similar arrangement with the mainland implemented before the Hong Kong one, but has a wider scope and fewer restrictive requirements.<sup>57</sup> During the negotiation, the Hong Kong government thought it necessary to limit the application of the Arrangement as there are significant differences in substantive laws between the Chinese civil law and Hong Kong common law systems; therefore, in order to maintain the consistency of common law principles, the development of mutual recognition with the mainland should take small steps.<sup>58</sup> A further concern on the Hong Kong side related to the soundness of the mainland's legal system. Since monetary judgment would be less controversial than enforcement of orders such as an injunction or a specific performance, it would be a good first step.

### **B. The requirement of Choice of Court Agreement**

Apart from the basic scope, the requirement for the choice of court created further limits on the application of the Arrangement. Article 3 further requires that there should be a signed agreement between the parties to indicate that either a Hong Kong or mainland court is to be the choice of court. However, such a requirement may raise some practical concerns. Generally, creditors do not always enter into a Choice of Court Agreement with their debtor company before the occurrence of a debt or dispute. This is especially true if both parties have a long-term business relationship or when the debtor company is still substantially solvent.<sup>59</sup> The official interpretation of the Arrangement published by the Supreme People's Court may provide some clarification about this issue, stating that "A 'choice of court agreement in

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<sup>56</sup> Article 3, The Supreme People's Court's Arrangement (n 51).

<sup>57</sup> *ibid.*

<sup>58</sup> Xiao Yongpin, 'The Conflict of Laws Between Mainland China and the Hong Kong Special Administrative Region: The Choice of Coordination Models', in *Yearbook of Private International Law* 163, 198 (2003).

<sup>59</sup> Emily Lee (n 15) 453.

writing' referred to in this Arrangement means any agreement in written form made . . . for resolving any dispute which has arisen or may arise in respect of a particular legal relationship."<sup>60</sup> This paragraph could be interpreted that even if there was no Choice of Court Agreement signed before the dispute arose by parties and was not a part of the main contract that gives rise to the debtor's payment obligation, a subsequent and separate Choice of Court Agreement can still be negotiated by relevant parties after the dispute occurs, so that the requirement under Article 1 will be satisfied.

If the interpretation solved part of the concern, the further issue is that whether parties are willing to designate mainland courts or a Hong Kong court as their choice of court. Some business parties might have deliberately avoided designating mainland Chinese courts to solve their cross-border cases. One reason would be that judicial uncertainty and corruption is still a serious issue in the mainland.<sup>61</sup> Although the problem has improved due to recent anti-corruption and judicial reform efforts introduced by President Xi's government since 2013, it remains a concern for some people who still believe that the mainland Chinese courts obstruct justice.<sup>62</sup> Concerned parties would thus avoid appointing any of the mainland courts as their court of choice. Furthermore, in practice, if two business parties need to reach an agreement about their future disputes, one could argue that arbitration would be a better choice for them since the process would be more effective and time-saving.<sup>63</sup> And the decision of arbitration could be recognised based on the Arrangement of Mutual Enforcement of Arbitral Awards between the Mainland and Hong Kong. So there would be no need to have a choice of court clause.<sup>64</sup> Consequently, it renders Article 1 of the Arrangement less attractive in practice.

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<sup>60</sup> Article 3, The Supreme People's Court's Arrangement (note 51).

<sup>61</sup> Ling Li, 'Corruption in China's Courts', in *Judicial Independence in China: Lessons for Global Rule of Law Promotion* 196, 201 (Randall Peerenboom ed., 2010).

<sup>62</sup> Emily Lee, (n 15), 449.

<sup>63</sup> Emily Lee, (n 15), 448; see discussion Jie Huang (n 37).

<sup>64</sup> *ibid.*

## 6.3 Practical Issues Relating to Insolvency Recognition

Extending the Arrangement to cover insolvency issues between the mainland and Hong Kong would be a possible option to close the insolvency law gaps between the two regions, since it is an existing regime that already serves the purpose of recognition and enforcement of judicial decisions, and the arrangement has already laid down a solid foundation for reciprocal judicial recognition and enforcement of judgments made by courts of either side. However, it has to be noticed that there have been a very limited number of cases that have applied the Arrangement since it was passed by both governments.<sup>65</sup> One of the main reasons for the limited application would be the two strict requirements discussed in the previous section. Furthermore, more practical issues have to be considered and solved if an effective insolvency recognition system is to be built based on the current Arrangement. For example, the official interpretation of the arrangement explains that employment contracts are not included in the application of the Arrangement.<sup>66</sup> Employment disputes, like unpaid salaries, are one of the important issues that are related to corporate insolvency cases. So, cross-border insolvency issues between the mainland and Hong Kong cannot avoid the issue of employee settlement.

### 6.3.1 International or Regional?

One important aspect of the Arrangement concerns the determination of jurisdiction, which is usually the main issue of judgment recognition between different countries. Since the legal systems are so different in the mainland and Hong Kong, the lawmakers from the two areas have treated recognition issues as if they were international ones, and have drafted the Arrangement based on relevant international conventions.<sup>67</sup> For example, the requirement of choice of court agreement was borrowed from the Hague Convention on

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<sup>65</sup> Zhihong Yun (n 36), 24.

<sup>66</sup> Article 3, The Supreme People's Court's Arrangement (note 51).

<sup>67</sup> Legislative Council of the Hong Kong SAR, Official Documents LC Paper No. CB(2)722/01-02(04) <<http://legco.gov.hk/yr01-02/english/panels/ajls/papers/aj1220-cb2-722-4e.pdf> > accessed 12 September 2017.

the Choice of Court Agreements of 2005, which was developed to solve jurisdiction issues of international cases and facilitate the recognition of foreign judgments.<sup>68</sup> International judgment recognition is a very sensitive issue since a legal judgment is a reflection of one nation's judicial sovereignty, and foreign-related jurisdiction issues have the potential of disrupting such sovereignty. Furthermore, a nation's economic interests are usually connected to such issues as well.<sup>69</sup> Therefore, one rationale for those international conventions is to protect national sovereignty.

However, it can be argued that the same solution for international issues may be not suitable for the China-Hong Kong issue since it is an interregional issue within one country. For international issues, the jurisdiction issue is important because national interests always come first.<sup>70</sup> For interregional issues, national sovereignty is not the main concern, so a system for recognition should focus on the protection of the parties' interests, and jurisdiction should not be the fundamental problem.<sup>71</sup> For example, under UK law, a court in one part of the UK cannot refuse to recognise a judgment from a court in another part of the UK solely on the grounds of lack of jurisdiction; in Australia, the federal government passed a unified law for judgments recognition among different states, and jurisdiction is not an issue to be considered during the recognition process.<sup>72</sup> Although the central government cannot make a unified law for judgment recognition as SARs enjoys judicial independence, except in the areas of diplomacy and national defence, it is important to raise the consideration that solutions for interregional issues should emphasise and reflect regional factors, and that a purely international approach under the current Arrangement would not be practical.

For insolvency issues between the mainland and Hong Kong, a recognition

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<sup>68</sup> *ibid.*

<sup>69</sup> Susan L. Steven, 'Commanding International Judicial Respect: Reciprocity and the Recognition and Enforcement of Foreign Judgments' (2002) 26 *Hastings Int'l & Comp. L. Rev.* 115.

<sup>70</sup> Xiao Yongpin (n 58), 170.

<sup>71</sup> *ibid.*

<sup>72</sup> Article 19, Civil Jurisdiction and Judgments Act 1982.

system should encourage the courts in both areas to work together for maximising the whole value of the assets and increasing the repayment rate. In order to do that, the jurisdiction issue could be important as only one main insolvency proceeding is preferred. The purpose of deciding the jurisdiction here is to find the most appropriate place to open such a dominating proceeding, and coordinate all the relevant parties in an effective order. It can then be distinguished from the jurisdiction rule under the current arrangement, in which the jurisdiction is limited to one place.<sup>73</sup> The purpose of this development would be to present a sound justification for having a separate jurisdiction rule specifically designed for interregional insolvency issues, and the suggestion is to borrow the concept of the COMI from the UNCITRAL Model Law, which will be discussed later in this chapter.

### **6.3.2 Different Criteria for Final Decision**

The Arrangement further requires that a judgment seeking recognition and enforcement has to be final.<sup>74</sup> The court of Hong Kong applies quite different criteria of finality from the mainland court. In the mainland, according to the Civil Procedure Law, all judgments and written orders of the Supreme Court, as well as judgments and written orders that may not be appealed against according to the law, or that have not been appealed against within the prescribed time limit, shall be legally effective.<sup>75</sup> That means that mainland courts hold that a judgment is not final if it has in fact been appealed or may potentially be subject to appeal. Additionally, the procedure of trial supervision is also stipulated in the law, which allowing judgment with legal effect to be reheard under certain circumstances.<sup>76</sup> The retrial can be conducted by the court rendering the original judgment or a court at the next higher level, as well as a court designated by the latter.

Both common law and statutory regimes require finality as a condition for a

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<sup>73</sup> Zhihong Yu (n 36), 25.

<sup>74</sup> Article 2, The Supreme People's Court's Arrangement (n 51).

<sup>75</sup> Article 155, the Civil Procedure Law 1991 (revised 2017) (China).

<sup>76</sup> Chapter 16: Trial Supervision Procedure, the Civil Procedure Law 1991 (revised 2017).

judgment to be recognised in Hong Kong. The judges make a decision based on Hong Kong law, and the law of judgment-rendering jurisdiction is considered as a reference. Because of the existence of a trial supervision process, a mainland judgment may not be considered final in a Hong Kong court.<sup>77</sup> For example, *Chan Chow Yuen v Nanyang Commercial Bank Trustee Limited* demonstrates mainland judgments cannot be recognised and enforced in Hong Kong because the two regions have different criteria on finality. In this case, the Court of First Instance in Hong Kong noticed that because mainland judgments were not considered as final in Hong Kong, so they were not recognisable and enforceable; consequently, the court suggested the parties re-litigate the case in Hong Kong in order to resolve their disputes. Nonetheless, in *Lee Yau Wing v Lee Shui Kwan*,<sup>78</sup> the Court of Appeal of Hong Kong held that, under the Arrangement, a judgment from the mainland could not be treated as not final or conclusive merely because of the existence of a trial supervision regime.<sup>79</sup> Although it seems that Hong Kong judges have taken a flexible approach, it is worth noting that the Mainland Judgment Ordinance uses the term “final and conclusive” instead of “final judgment with enforceability” which was used in the original document.<sup>80</sup> Therefore, there is still uncertainty on the finality matter. As for the issues of cross-border insolvency, such uncertainty and strict requirement would be another obstacle to recognition and assistance.

### 6.3.3 Grounds for Refusing Recognition

The Arrangement provides different grounds to refuse recognition of judgments from the other jurisdiction; for example, the absence of a valid choice of court clause, unfair procedure, fraud and public policy can all be refusal reasons.<sup>81</sup> Article 9 of the Arrangement states that recognition and enforcement of a judgment shall be refused if the Chinese court considers that

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<sup>77</sup> *Chiyu Banking Corporation Ltd. v Chan Tin Kwun* [1966]1HKLR 395.

<sup>78</sup> *Lee Yau Wing v Lee Shui Kwan* [2005] HKCA657.

<sup>79</sup> *Lee Yau Wing v Lee Shui Kwan* [2005] HKCA657, at 75-77.

<sup>80</sup> Section 6 (1), Mainland Judgments (Reciprocal Enforcement) Ordinance (HK).

<sup>81</sup> Article 9, The Supreme People's Court's Arrangement (note 51).

enforcement of a judgment made by a Hong Kong court is contrary to the social and public interests of the mainland. Likewise, the Hong Kong courts can also consider refusing to enforce a judgment made by the Chinese court if enforcement would be contrary to the public policy of Hong Kong. Traditionally, the similar public policy rules are related to national interests or public order. Since Hong Kong is part of China, the public interest or order of Hong Kong is part of the public interest or order of China. Hence, the public policy under the content of the Hong Kong-China relationship is different.<sup>82</sup> There are similar articles about public policy in different international laws, and the word “manifestly” is usually added to make sure or encourage that such an article will not be invoked so easily as to harm the effectiveness of international law. Thus, the interpretation of the public policy should consider the benefits shared by both jurisdictions, and reflect the special relationship between the two regions under the “one country, two systems” concept.<sup>83</sup>

#### **6.4 UNCITRAL Model Law: Lessons for Mainland-Hong Kong Matters**

As discussed in previous chapters, the UNCITRAL Model Law on Cross-border Insolvency has been recognised as one of the best examples promoting the concept of universalism and courts cooperation for solving international insolvency issues, and has been adopted by various developed countries.<sup>84</sup> Although it still has some uncertain issues, it cannot be denied that the system offers some factors that improve the efficiency of multinational insolvency solutions.<sup>85</sup> The main concept behind the law, modified

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<sup>82</sup> Sikai Chen, ‘The Study on the Judgment Recognition and Enforcement between Mainland China and Hong Kong’ (Thesis, North China University of Technology 2011).

<sup>83</sup> *ibid.*

<sup>84</sup> Leah Barteld, ‘Cross-Border Bankruptcy and the Cooperative Solution’ (2013) 9 *Brigham Young University International Law & Management Review* 27.

<sup>85</sup> Fernando Locatelli, ‘International Trade and Insolvency Law: Is the UNCITRAL Model Law on Cross-Border Insolvency an Answer for Brazil’ (2008) *Law and Business Review* 313.

universalism, has been well-recognised by most of the countries as well.<sup>86</sup> Although the bulk of the world has not been convinced by the law, it does not mean that those countries are satisfied with their current insolvency systems. Having a comprehensive commercial law system has been a very important foundation for developing a country's economy, and an insolvency system has always been treated as one of the essential links.<sup>87</sup> The advantages and efficiency of the universalism approach cannot be ignored by those reform processes, and the reasons that some of the countries keep the territorialism approach and remain uncommitted to a universal system is not totally about the universalism approach or the UNCITRAL Model Law itself. For instance, national sovereignty could be one of the main concerns outside of the scope of the Model Law.<sup>88</sup> It has been argued that a globalised insolvency system should reflect an "optimal blend of competition and cooperation across international borders and must take account of local custom, culture and history."<sup>89</sup> Because of those non-law concerns, although the advantages of universalism are obvious, the debate between universalism or territorialism is still on-going when dealing with cross-border insolvency cases among different countries. The point is that the universalism approach has to be more nuanced, textured and localised if it is to succeed in developing countries.<sup>90</sup>

#### **6.4.1 Universalism as Foundation**

Due to the political arrangement between the mainland and Hong Kong, it seems that the universalism and territorialism approaches co-exist within one

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<sup>86</sup> Kent Anderson, 'The Cross-Border Insolvency Paradigm: A Defense of the Modified Universalism Approach Considering the Japanese Experience' (2000) *U. PTA. J. Int'l Econ. L.* 679.

<sup>87</sup> Daniel Berkowitz, Katharina Pistor, and Jean-Francois Richard, Economic Development, 'Legality, and the Transplant Effect' (2000) William Davidson Institute Working Paper Number 308, <<https://deepblue.lib.umich.edu/bitstream/handle/2027.42/39692/wp308.pdf?sequence=3&isAllowed=y>> accessed 20 September 2017

<sup>88</sup> Frederick Tung, 'Is International Bankruptcy Possible?' (2001), 23 *MICH. J. INT'L L.* 31, 101.

<sup>89</sup> *ibid.*, 101.

<sup>90</sup> Sandeep Gopalan and Michael Guihot, 'Recognition and Enforcement in Cross-Border Insolvency Law: A Proposal for Judicial Gap-Filing' (2015) 48 *VAND. J. TRANSNAT'L L.* 1225.

country. The mainland is a good example of a conservative approach towards the universal system.<sup>91</sup> Although its insolvency system has acknowledged some ideas based on the spirit of universalism, such as the possibility of recognition and cooperation of foreign proceedings, however, only one article under the insolvency system has any practical application, and territorial solutions are still applied by the courts. On the other hand, because of the influence of the common law tradition, universalism has been well-accepted by the courts in Hong Kong. Its statutory regulations have included solutions for international issues, which reflect some universalism concepts too.

The purpose of modified universalism is to find a balance between purely territorial and universal approaches.<sup>92</sup> Since it has been proved by the UNCITRAL Model Law and the European Regulation on insolvency proceedings that the system could improve the efficiency of cross-border cases, the argument here is that the modified universalism approach could be used to solve insolvency issues between the mainland and Hong Kong. Since neither China nor Hong Kong has adopted the Model Law, the best idea would be to borrow some concepts from the universal system and implant those into the domestic legal system. The advantages of doing so will be analysed below.

#### **6.4.2 Applying COMI for Regional Matters**

From the analysis above, it is clear that there are many differences between the two jurisdictions' insolvency systems due to their totally different legal systems bearing that in mind, it is not an exaggeration to say that the cross-border insolvency issues within China are no easier to solve than international ones.<sup>93</sup> Each issue has to be resolved by using small steps. Such a situation is similar to the development of the UNCITRAL Model Law, which focuses on facilitating the recognition of foreign proceedings, not on harmonising different

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<sup>91</sup> Wantao Yang and Sheng Chen, 'The Theory and Practice of Cross-Border Insolvency in China' (2012) 3 *Financial Service and Law Review* 338.

<sup>92</sup> Sandeep Gopalan and Michael Guihot (n 90), 1225.

<sup>93</sup> Xiahong Chen, 'How to Set Up the Cross-Border Insolvency System between Mainland China and Hong Kong' (Legal Daily 2016).

insolvency laws.<sup>94</sup> It suggests that the starting point for the solution of any China-Hong Kong problems should also be the recognition issue.

There are two paths that are available for seeking recognition between the mainland and Hong Kong.<sup>95</sup> The first is to start a proceeding seeking recognition directly based on the local law in the other jurisdiction. The problem is that it is very difficult for the mainland courts to recognise proceedings from other jurisdictions under the current corporate insolvency law. The second path is to have a specialised recognition regulation or arrangement between the two regions. It has been discussed in this chapter that the current recognition system for civil and commercial matters is not suitable for insolvency cases, and one of the main issues is to decide which jurisdiction is more appropriate to deal with the insolvency. The concept of the COMI could be a solution.

The UNCITRAL Model Law identifies foreign proceedings as main or non-main proceedings based on companies' COMI locations. By using the concept of COMI, the main insolvency proceeding will be decided by the management or operational centre of the company. Currently, both the mainland and Hong Kong decide the location of the proceeding based on the domicile of the company or its assets, so it is very common that courts from both jurisdictions would claim they have the right for opening the main proceeding, which could cause conflict when seeking recognition because it could be denied on the ground of lack of jurisdiction. With the introduction of the COMI, such a conflict would be avoided. For instance, if a judgment from Hong Kong is seeking recognition in the mainland, the mainland court would use the COMI to decide whether Hong Kong is the COMI of the insolvent company. If it is, the mainland

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<sup>94</sup> Article 15 as a whole, UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, para 127-128; see also Jenny Clift, 'The UNCITRAL Model Law on Cross-Border Insolvency- A Legislative Framework to Facilitate Coordination and Cooperation in Cross-Border Insolvency' (2004) 12 *Tul. J. Int'l & Comp. L.* 307.

<sup>95</sup> Liangling ling and Yuying Zeng, 'The Conflicts and Cooperation on Cross-Border Insolvency Between Mainland China and Hong Kong' (2015) *Mudanjiang University Journal* 22.

court should recognise the proceedings as the main proceeding and give effect to the Hong Kong judgment, subject to the local public policy. If the COMI is on the mainland, the recognition should be rejected and Hong Kong proceeding should be willing to cooperate with the mainland existing or future proceeding against the insolvent company.

Since both governments have the same intentions to encourage closer economic cooperation and movement between the mainland and Hong Kong, such solid economic foundation should encourage courts from both jurisdictions to trust the counterparty.<sup>96</sup> It means that the court for the main proceeding should receive full cooperation and assistance from the other participant courts. Such a system should be possible within China, and the advantages will benefit both jurisdictions separately or as a whole. Legally, a solution with the concept of the COMI would solve the recognition issue caused by the fundamental differences between two insolvency law systems. Since it is impossible to harmonise the two insolvency systems, there has to be a new approach facing the increasing number of interregional cases. Furthermore, although it is about a solution between two different jurisdictions within one country, introducing the COMI would be an important step for the Chinese insolvency system. The key significance is that it would be an example and practice of universalism under Chinese law, which gives Chinese courts more experience dealing with cross-border insolvency, and provides references for cases from other foreign jurisdictions.

Politically, the suggested approach with the COMI solves the current political dilemma, and which would stop treating Hong Kong insolvency cases as totally foreign cases. In fact, it requires more specialised regulations for solving mainland-Hong Kong issues if the two political and legal systems are to co-exist and work within one country; since the political arrangement is innovative, the legal issues should be solved innovatively as well.<sup>97</sup> Hence, an effective way for solving insolvency issues would reflect the closeness of

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<sup>96</sup> *ibid.*

<sup>97</sup> Yousong Huang, 'The Development of Judicial Assistance between Mainland and SARs under 'One Country, Two Systems'' (2007) *China Law* 8.

the political and economic relationship between the two areas.

Economically, the barriers to doing business have been lowered because of the introduction of the Closer Economic Partnership Arrangement (CEPA), which has led to an increase in the number of corporations having assets and creditors in both jurisdictions.<sup>98</sup> With such an economic arrangement, it is fair to have a corresponding regulation providing an effective solution for those companies when they are in financial difficulties. Even more so as foreign investors see Hong Kong as an important channel for getting into the mainland market. A clear inter-regional insolvency system would improve both places' competitive advantage as a whole. To sum up, the political and economic relationship could provide a solid foundation for adopting a COMI-based interregional insolvency regime.

## **6.5 Conclusion and Recommendations**

With the quick growth of globalisation, interregional economic integration should accompany such a development so that all participating regions can achieve the best comparative advantages. The mainland and Hong Kong's relationship requires such an interregional support system. Regarding the insolvency issues between the two regions, investors from both regions would like to see a clear and predictable legal system for doing business, and an effective insolvency system is one of the main parts of such a system. Since the millennium, the two regions have made joint efforts to realise the free circulation of goods, services, capital and people between them, and the mainland has become one of Hong Kong's most significant trading partners. A quick and effective insolvency system would encourage regional economic stability and development. Apart from the economic grounds, the legal community also has high expectations of having a better interregional

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<sup>98</sup> Henry Chun Kwok Lei, 'The Closer Economic Partnership Arrangement (CEPA) and its impacts on the export efficiency of Hong Kong and Macao' (2017) 15 *Journal of Chinese Economic and Business Studies* 141.

insolvency system. The constitutional framework created by the policy of “one country, two systems” brings both necessities and possibilities to the development of a more efficient legal relationship between courts from both regions. Treating cases from the other jurisdiction as a total international issue is obviously not beneficial to the regional economy, nor is it the intention under the political arrangement. Furthermore, the intervention of the government in insolvency proceedings is not always avoidable because of the history of the planned economy. Such role can be used as a tool of local protectionism where the insolvency case is connected to the economic interests and political achievements of the local government. So, an insolvency regulation with detailed guidance is required to give the courts powers to solve insolvency problems with confidence, and reduce the level of involvement of local government.

The chapter suggests that the recognition of an insolvency judgment should be the foundation of the new law. Extending the current judgment recognition arrangement between the mainland and Hong Kong to cover cross-border insolvency issues would not be possible because of the limited scope and application borrowed from international conventions. So, it would be recommended that a new regulation that focuses on cross-border insolvency and uses the current recognition arrangement as a framework, modifying specific sections based on the principle of the UNCITRAL Model Law, be introduced.

Regarding the scope of the proposed arrangement, the requirements of monetary judgment and choice of court agreement should both be removed. The judgments for insolvency cases are not always monetary. For example, specific performance may be ordered to submit some necessary documents relating to the debtors’ assets. In Hong Kong, a liquidator may be appointed by the court to manage a debtor’s assets located in both the mainland and Hong Kong, so the recognition of the Hong Kong judgment may be about the recognition and powers of the liquidator in the mainland. Generally, the choice of court agreement may not be discussed between debtor and creditor before the proceeding.

Another suggestion is that the rule of jurisdiction should be modified, and it should focus on the protection of parties' interests and finding the appropriate court for dealing with the whole insolvency process. Since both mainland and Hong Kong agree that universalism is the better way to solve cross-border insolvency (although the attitude of mainland China requires further observation), the idea of deciding main and non-main proceeding by the COMI can be borrowed from the UNCITRAL Model Law for the mainland - Hong Kong issues. The COMI should be the operational and managerial centre of the company, and the court where the COMI is located should have the right to open the main proceeding, so the court in the other jurisdiction should provide full cooperation. In order to do that, the proposed arrangement should include the possibility of direct communication between the courts. It would be useful for the courts to collect all the relevant information for deciding the COMI; additionally, such communication would give the courts more powers to find a better solution together, and could avoid any potential interference from the local government.

Another issue from the current arrangement is the difference of final judgment between the two jurisdictions. It is suggested that the Supreme Court could be asked to provide further clarifications about the proposed arrangement. The section that is refusing recognition based on public policy should be kept; however, the application of such a section should be limited. Taking the Model Law as an example, it suggests adding the word "manifestly" before "contrary to the social and public interests", which suggests such an article will not be easily applied, and run the risk of harming the effectiveness of the arrangement. Hong Kong and the mainland are two jurisdictions within one country, and there are shared public interests, so the interpretation and application should be more careful and restricted.

## Chapter 7 Corporate Group Insolvency

Through the review of international development in cross-border insolvency based on Chapter 2 and 3, insolvency of corporate group has been actively discussed under both the European regulation and the Model Law regimes. Although the current provisions of the Model Law do not include rules governing enterprise groups, more efforts have been put into this area by the Working Group.<sup>1</sup> Chinese corporate groups at both national and international levels have developed significantly due to a series of reforms of state-owned enterprises and investment policies over the years. However, with the increasing number of state-owned enterprise groups and multinational enterprise groups in China, relevant issues have not been addressed in Chinese insolvency system. Therefore, the purpose of this chapter is to review the current status on the subject of corporate group insolvency at both domestic and international level, and discuss practical and potential developments of Chinese insolvency system accordingly. This chapter is continuing discussion following Chapter 4, which connect to the third research question for identifying legal gaps under Chinese insolvency law. This chapter is necessary

Therefore, the first part examines the nature of corporate groups and why it is becoming a complicated issue under the insolvency law. Then, the second part reviews the legal meaning of a corporate group under Chinese law. Specifically, the influence of state-owned enterprises reform on the rise of Chinese corporate groups will be discussed in detail. The approach adopted by Chinese judges for solving corporate insolvency and its potential issues are considered in part three. The last part discusses the international principles regarding this matter, and possible influences on the future development of Chinese law.

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<sup>1</sup> For example: UNCITRAL Working Group V, Facilitating the Cross-border Insolvency of Multinational Enterprise Groups: Key Principles (December 2015); Facilitating the Cross-border Insolvency of Multinational Enterprise Groups: Draft Legislative Provisions (December 2016).

## 7.1 Corporate Groups and Insolvency

The UNCITRAL Working Group uses the phrase “enterprise group”, and defines it as “two or more enterprises that are interconnected by control or significant ownership”, and the MEG Guidelines give the definition of “multinational corporate groups” as “those companies established in more than one country which are linked together by some form of control, whether direct or indirect, or ownership, by which linkage their businesses are centrally controlled or coordinated.”<sup>2</sup> The European Regulation on insolvency proceedings gives a succinct definition, saying that a corporate group consists of parent and subsidiary companies.<sup>3</sup> Generally, all those definitions reflect the fact that companies within a group are separate entities.

### 7.1.1 Benefits of Corporate Groups

Those distinct legal entities provide flexibility for dealing with business in different countries, which is the most significant benefit of corporate groups, and which also makes it difficult to achieve a universal system for their insolvency.<sup>4</sup> The structural flexibility allows the parent company to limit its liability for the subsidiaries’ debts; moreover, it gives the parent company the opportunity to separate business risks among companies.<sup>5</sup>

Risk allocation could reduce the possibility of insolvency of the whole group.<sup>6</sup> The parent company could make sure that each legal entity within the group

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<sup>2</sup> Working Group V, ‘Facilitating the Cross-border Insolvency of Multinational Enterprise Groups: Draft Legislative Provisions’ Working paper A/CN.9/WG.V/WP.146. < <https://documents-dds-ny.un.org/doc/UNDOC/LTD/V17/013/64/PDF/V1701364.pdf?OpenElement>> accessed 9 September 2017.

<sup>3</sup> Article 2 (13), Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on Insolvency Proceedings.

<sup>4</sup> Nora Wouters and Alla Raykin, ‘Corporate Group Cross-Border Insolvencies Between the United States & European Union: Legal & Economic Developments’ (2013) 29 Emory Bankruptcy Developments Journal < <http://law.emory.edu/ebdj/content/volume-29/issue-2/article/corporate-group-cross-border-insolvencies.html>> accessed 9 September 2017.

<sup>5</sup> *ibid.*

<sup>6</sup> *ibid.*

has an easily ascertainable level of risk, which is independent from the other subsidiaries.<sup>7</sup> If one subsidiary meets financial difficulty, the parent company may evaluate the situation and decide whether to save it, or require it to file insolvency for the group's health. Such a risk allocation system is also preferred by different types of creditors.<sup>8</sup> However, one subsidiary failure could lead to group failure. Most cases filed under the European Regulation involved corporate groups.<sup>9</sup> The reason is that the internal structure within a group can be varied, and it could be decentralised or centralised. For decentralised groups, the foreign subsidiaries may have little connection with their parent, and operate independently. On the contrary, companies within centralised groups are deeply involved with each other, and subsidiaries in a different country may operate under a single identity even they all have an independent legal identity. The parent company will make sure its business decisions are fully performed by its subsidiaries, and for the best interests of the whole group. So, one failure may cause a chain reaction within centralised groups.

### **7.1.2 Insolvency of Corporate Groups**

Based on the previous chapters, it is clear that a multinational insolvency issue is one of the inevitable results of the increase of business globalisation, and the complicated issue requires a specially-designed legal mechanism to facilitate those problems with international elements. Some of the complexities are caused by the differences in relevant laws of the involved jurisdictions, or the legal proceeding itself; sometimes it is possible that the insolvency process is more complex because of the structure of the insolvent enterprise. The insolvent company may be a single debtor having international operations or relations, such as one insolvent company with various branches in different countries; or a company holding assets or properties around the world; or a company simply having foreign creditors. A more complicated

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<sup>7</sup> Irit Mevorach 'Appropriate Treatment of Corporate Groups in Insolvency: A Universal View' (2007) 8(2) *European Business Organisation Law Review* 179.

<sup>8</sup> *ibid.*

<sup>9</sup> Nora Wouters and Alla Raykin (n 4).

situation is the failure of an international corporate group. Corporate groups often have branches or subsidiaries all over the world. Although those affiliated companies are legally separated, their business activities can be tied together in different ways. For example, a corporate group has a centralised structure, and the insolvent member may be deeply connected with the activities of another member: then one insolvency may lead to another member's insolvency, and possibly the collapse of the whole group. The insolvency issues of those groups could be more chaotic and require specially-tailored laws.<sup>10</sup> In fact, since the corporate group is the most typical organisational structure of multinational enterprises, the discussion for solving cross-border group insolvency issues have been going for decades as a result of the failure of several large international corporate groups.

It has been argued that one of the weaknesses of the current UNCITRAL Model Law is that it only applies to distinct legal entities. The UNCITRAL Working Group did realise the importance of addressing the enterprise group insolvency, but the issue was thought to be too difficult to address at that time, and further discussions were required. So, their work on corporate group insolvency resulted in the publication of Part 3 of the Legislative Guide on Insolvency Law, which provides guidance dealing with enterprise group insolvency at both domestic and international level. Currently, the discussions and negotiations for drafting a set of provisions on enterprise groups to supplement the current model law are still in progress.

### **7.1.3 Conflicts with Entity Separateness**

Under most of the insolvency regimes, corporate entity separateness is recognised. However, the respect for separateness is the most significant difficulty in solving cross-border group insolvency.<sup>11</sup> Similar to the individual company's insolvency, one of the main purposes for group insolvency is to increase the efficiency and maximise the value of the assets of the enterprise

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<sup>10</sup> Simona Di Sano, 'The Third Road to Deal with the Insolvency of Multinational Enterprise Groups' (2011) *Journal of International Banking Law and Regulation* 15.

<sup>11</sup> *ibid.*

as a whole. According to the universalism and territorialism debate, the best way to achieve this goal would be through a single principal insolvency proceeding, which could also ensure procedural fairness and equal treatment of all creditors.<sup>12</sup> One centralised proceeding would reduce the costs, increase the efficiency, offer a forum for cooperation among all the parties, and compare relevant options. The additional consideration for group insolvency here is that the courts also have to consider the legal status of separate entities as well. Basically, the idea of one single proceeding is a conflict with the intention of having separate legal entities for subsidiaries, and it would lead to two inherent difficulties.

The first inherent issue is that it is difficult to ascertain the proper jurisdiction to open and govern the principal proceeding since different entities are possibly incorporated or operating in different jurisdictions.<sup>13</sup> Deciding on the centre of main interests for one single debtor has already caused many issues under current international insolvency systems; so it can be seen that deciding on the most appropriate forum for a whole group could be more problematic. Furthermore, the legal principle of a separate entity is at the heart of most legal systems, which means it is difficult for countries to accept the possible interference in domestic policies if one single proceeding is in charge of the group insolvency.<sup>14</sup> The second difficulty is caused by the different organisational structures of corporate groups. As mentioned earlier, the operation of one group could be centralised or decentralised. It could be the case that the group is centrally managed, and the members' assets and debts are linked to each other, and its management and decision-making centre could be in one specific country; or it could be the case each subsidiary enjoys a high degree of autonomy in business activities within its national regime, and the relationship with its parent is only a legal agreement.<sup>15</sup> Accordingly,

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<sup>12</sup> Andrew T Guzman, 'International Bankruptcy: in Defense of Universalism' (2000) 98 *Mich.L. Rev.* 2177.

<sup>13</sup> Irit Mevorach (n 7).

<sup>14</sup> Irit Mevorach, 'The Road to a Suitable and Comprehensive Global Approach to Insolvencies Within Multinational Corporate Group' (2005) (PhD Thesis University College London 2006).

<sup>15</sup> Nora Wouters and Alla Raykin (n 4).

the approach of one single proceeding may be more applicable to those centralised groups, but unsuitable to the decentralised ones. Therefore, it is important to consider the influence of the degree of integration of control in group insolvency as it can drive the debate about whether it is possible to have a unified insolvency approach for corporate groups.<sup>16</sup>

## 7.2. Corporate Groups in China

As mentioned in this thesis, the development of the Chinese insolvency system has been very slow, and there is only one article addressing cross-border insolvency issues under the latest reformed enterprise insolvency law. The law does not consider the issues of corporate group insolvencies. In fact, the regulation of corporate groups is very limited under the current Chinese legal system, and obviously, it does not match the significant development of the Chinese economy. The numbers of both domestic and international corporate groups are increasing with the influence of globalisation and the Chinese open-up policies.<sup>17</sup> Domestically, most of the large Chinese companies are members of the corporate group. It can seem that many Fortune 500 companies indicate their group in their names. State-owned enterprises are a big part of the Chinese economy, and the corporate group is a very common structure, one that profitable SOEs would choose.<sup>18</sup> With the implementation of a new, investor-friendly company law in 2013, it can be predicted that the number of enterprises will continue to grow as the law reduces the barriers for establishing companies. Furthermore, the equal development of the private and public sector is encouraged following the government strategy of developing a market-oriented economy. Therefore, the increase of both state-owned and private-owned corporate groups can be expected.<sup>19</sup> Internationally, China is in a good position for both inbound and

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<sup>16</sup> Irit Mevorach (n 14).

<sup>17</sup> Junhai Liu, 'Regulation of Corporate Groups in China', in Holger Fleischer *et al* (eds.), *German and Asian Perspectives on Company Law* (Mohr Siebeck 2016).

<sup>18</sup> *ibid.*

<sup>19</sup> *ibid.*

outbound international investment. Most international multinational companies have their subsidiaries or branches in China, and more Chinese companies are trying to expand their business groups globally.<sup>20</sup> Therefore, urgent action is required to have proper laws specially tailored for regulating corporate groups in China.

The definition of the corporate group under Chinese laws is not clear. There are limited provisions from different branches of the law addressing the issues between the parent company and its subsidiaries, but none of them gives a comprehensive explanation of what corporate groups are.<sup>21</sup> The 2013 Chinese Company Law has one article for this matter, which only clarifies that the subsidiary has a separate legal personality.<sup>22</sup> Contrary to the slow development of legislation, Chinese scholars have been trying to clarify this concept. For example, Professor Shao noted the purpose of developing group structure is to achieve centralised management and improve profitability as a whole, and defined corporate groups as organisations consisting of two or more enterprises, with all the members having a separate legal identity and all accepting integrated control and management in financial policies; Dr He also pointed out that the essence of the definition of corporate groups in a legal context is whether there is a unified control and management system for all the members, as such a system ensures the organisational and integrated nature of the group.<sup>23</sup> In fact, the meaning of the management and control system here can be explained by referencing the work from UNCITRAL. In their draft provisions for enterprise groups' issues, 'control' means one enterprise's capacity to determine, directly or indirectly, the operating and financial policies of another.<sup>24</sup>

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<sup>20</sup> *ibid.*

<sup>21</sup> Hanjiang, He 'The Conception of Making Corporate Group Law in China' HF Library <<http://www.hflib.gov.cn/law/law/falvfagui2/JJF/LWJ/1069.htm>> accessed 20 June 2017.

<sup>22</sup> Article 14, The Company Law of PRC.

<sup>23</sup> Hanjiang, He (n 21).

<sup>24</sup> Working Group V, 'Facilitating the cross-border insolvency of multinational enterprise groups: draft legislative provisions' Working paper A/CN.9/WG.V/WP.146. <<https://documents-dsny.un.org/doc/UNDOC/LTD/V17/013/64/PDF/V1701364.pdf>>.

Therefore, at least two common characteristics of corporate groups can be identified as follow: 1. each member has its own legal identity; 2. all members operate for the best interests of the whole group, and are connected through a centralised management system. Understanding these two basic factors would be the starting point for addressing corporate group issues in a Chinese law context.

### *SOEs Reform and Development of Corporate Groups*

As mentioned earlier in this chapter, insolvency of one company within a group could lead to more insolvencies of other members, or even the collapse of the whole group; so having a proper system under an insolvency system to help such groups to find the best solution is important. The importance for China is not just about having a more comprehensive enterprise insolvency system; it is also related to building a stable economic and legal environment for the further reform of the state-owned enterprises, and the development of the market-oriented economy.

State-owned enterprises are still playing vital roles in the Chinese economy, especially in some basic industries, such as energy, construction and telecommunications.<sup>25</sup> Both state-owned and private corporate groups are outcomes of the on-going reform of SOEs, which is a very slow and complicated process. The first stage of the reform started in 1980. During that time, SOEs accounted for 78% of China's gross industrial output.<sup>26</sup> With the marketisation of China's domestic economy, and the liberalisation of trade and foreign investment, the government started to corporatise the SOEs.<sup>27</sup> The purpose was to reform the management systems to achieve better productivity and profitability in the SOEs.<sup>28</sup> The second reform period started from the

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<sup>25</sup> Gary Jefferson, 'State-Owned Enterprise in China: Reform, Performance, and Prospects' (2016) (working paper, The Sage Handbook of Contemporary China), 8.

<sup>26</sup> *ibid*, 9.

<sup>27</sup> *ibid*.

<sup>28</sup> Chong-En Bai, Jiangyong Lu and Zhigang Tao, 'The Multitask Theory of State Enterprise Reform: Empirical Evidence from China' (2006) 96 *The American Economic Review* 353.

mid-1990s and it was largely motivated by the determination to ready China for membership of the World Trade Organisation.<sup>29</sup> This stage was called “retain the large, release the small”, which meant retain large SOEs in important sectors, and privatise smaller SOEs. By 2004, the number of such SOEs had decreased significantly from 118,000 in 1995 to 24,961.<sup>30</sup> The ownership of those companies has been transferred to managers, workers or private investors. More importantly, the policy also led to growing merger and acquisition activity and the early development of corporate groups.<sup>31</sup> In the new century, the Chinese government started the third stage of reform, and one of the main purposes is to restructure the large SOEs and improve their competitive advantages in the global market.<sup>32</sup> Accordingly, the increase of the state-owned corporate groups has been significant during this period. Commonly, state-owned groups are formed based on government support or administrative orders.<sup>33</sup> A typical example would be the Sinopec Group, which ranked 4<sup>th</sup> in the global 500 list.<sup>34</sup> The group was formed directly by the central government, and it included 12 petroleum companies, 14 refinery companies and hundreds of smaller energy companies from different provinces.

There are inherent issues relating to state-owned corporate groups, and one of the remedies would be to have a comprehensive insolvency and restructuring system for groups. The first issue of state-owned corporate groups is that their business operations mainly depend on government strategy or administrative guidance, and continuing funds from the government.<sup>35</sup> The result is a lack of creativity and business sensitivity;

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<sup>29</sup> Gary Jefferson (n 25), 10.

<sup>30</sup> *ibid.*

<sup>31</sup> Fan Gang and Nicholas C. Hope, ‘The Role of State-Owned Enterprises in the Chinese Economy’ (2013) *China-US 2022: Chapter 16*, 5 <[www.uschina2022.com](http://www.uschina2022.com)> accessed 12 July 2017.

<sup>32</sup> *ibid.*

<sup>33</sup> Dake Yang, ‘Enterprise Group Legislation Mode Selection in China from the Perspective of Comparative Law’ (2016) *Journal of Tongji University Social Science Section* 110.

<sup>34</sup> Fortune, ‘Global 500 list’ <<http://fortune.com/global500/>> accessed 12 September 2017.

<sup>35</sup> Dake Yang, (n 33); see also Jin Deng, ‘The Research on the legislation for Insolvency of Multinational Corporate Group’ (2013) *Politics and Law* 5.

Chinese scholars describe such situations as “easy to be big, difficult to be strong”.<sup>36</sup> The second issue is that all the members of state-owned groups were connected as a result of the political drive, so the economic connection among them is not strong. This means it would be difficult, or take a long time, to have a unified management system to fit all the members. One of the results would be that the parent company would have to be in charge of everything, and members would lose autonomy and motivation.<sup>37</sup>

Both issues would lead to an imbalanced development between the parent company and its subsidiaries, and the result of such an imbalance is zombie companies within a group. Usually, if the group is still getting money from the government, those zombie companies will not enter the insolvency process, and continue to exist.<sup>38</sup> If there is more than one zombie company, it will be a big burden on the group and the government. A group insolvency regulation would provide a solution for such situations, as a restructuring plan may be proposed for a healthier structure. Furthermore, the Chinese government has been promoting the further strategy of developing a market-oriented economy. This means the intervention of the government in business activities should be reduced and the market be allowed to play the main role. Although it would be impossible to expect the government role to disappear, it cannot be denied that the SOEs have been given more freedom to play on the international platform.<sup>39</sup> As SOEs are more involved in the market rules, the insolvency system should be the appropriate solution for when they are having financial difficulties.

The development of private corporate groups may be steadier since they usually expand gradually, playing the rules of the market. However, some

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<sup>36</sup> State-Owned Enterprises Reform: Stronger, Better and Bigger (Economic Daily News, 20,04,2017).

<sup>37</sup> Dake Yang (n 33).

<sup>38</sup> Shaoqing Huang and Yan Chen, ‘The Distribution Characteristics and Solution Strategy for Zombie Enterprises in China’ (2017) *China Industrial Economics* 24.

<sup>39</sup> Yongnian Zheng and Minjia Chen, ‘China’s Recent State-Owned Enterprise Reform and Its Social Consequences’ (2007) Briefing Series, China Policy Institute, University of Nottingham Issue 23.

groups, especially those which used to be state-owned companies, might make a risky investment or business decision in the free market. By using the connection among the different members, a large-scale financial operation is possible through ways such as connected transactions or excessive finance.<sup>40</sup> The result is all the members are closely connected, and one member's issue may lead to the failure of the whole group. In such situations, a group insolvency system is required in order to maximise the repayment for creditors.

### 7.3 Solving Corporate Group Insolvency in China

Based on the analysis above, the main reason causing the complexities of corporate group insolvencies is the application of the separate legal entity doctrine. Although the traditional rule should be and has been recognised and respected under both domestic and international legal regimes, it cannot be denied that with the rapid development of corporate groups, the doctrine can be used by group management teams for certain liability or financial reasons, which would blur the lines between separate group members.<sup>41</sup> One corporate group could be managed as a single commercial entity with extensive interchange of assets or funds among group members, so the assets and liability may not be clearly separated.<sup>42</sup> The highly-connected assets and funds among members could be one of the common factors that is shared by the insolvency of big corporate groups in recent years.<sup>43</sup> However, it is important to remember that the management structure could vary in different groups. The insolvency could be the whole group, or only one or several members within the group. Therefore, the dilemma for regulating corporate group insolvency is that it has been realised that solving insolvency members individually may be not beneficial to the whole group, but it could be

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<sup>40</sup> *ibid.*

<sup>41</sup> Heribert Hirte, 'Towards a Framework for the Regulation of Corporate Groups' Insolvencies' (2008) *ECFR* 213.

<sup>42</sup> *ibid.*

<sup>43</sup> Arie Van Hoe, 'Enterprise Groups and Their Insolvency: It's the (Common) Interest, Stupid!' (2014) *ECFR* 200.

difficult to have one solution to fit all different types of group insolvency cases; more specifically, what standards should be used to differentiate the different types?<sup>44</sup>

Since there are many SOEs existing as corporate groups, and they are vital to the stability of Chinese economy, it is important that the Chinese commercial law system has an effective system for insolvency of corporate groups. At the domestic level, some developed countries have been making efforts to build an effective group insolvency system. For example, the New Zealand courts have the statutory pooling power for solving group insolvency, which allowing the assets of the whole insolvent group to be used to satisfy the debts owed by each member of the group.<sup>45</sup> The bankruptcy courts of the United States have similar powers called ‘substantive consolidation’.<sup>46</sup> As a matter of fact, although the latest Chinese insolvency law did not mention corporate groups, Chinese judges have applied a similar approach in practice for solving the increasing number of issues of corporate group insolvencies.

#### *Court-developed Approach*

Since there is no common law system in China or relevant articles under the insolvency law or other commercial laws, the approach of ‘consolidation’ was developed by the courts in practice, and has received academic support.<sup>47</sup> At least 15 case reports can be found in the official judgments publication website

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<sup>44</sup> Irit Mevorach, ‘Is the Future Bright for Enterprise Groups in Insolvency? – Analysis of UNCITRAL’s New Recommendations on the Domestic Aspects’ in *International insolvency law: challenges and reforms* (Ashgate 2012) 363.

<sup>45</sup> Section 271, 272, the Companies Act 1993 (New Zealand).

<sup>46</sup> *Sampell v Imperial Paper and Color Corp* 313 US 215 (1941): Supreme Court case recognised substantive consolidation “Substantive consolidation can be seen as a multi-party version of veil piercing. Instead of simply permitting a single creditor to pierce the corporate veil, the court collapses the corporate structure altogether, pooling all the assets and claims of the group”.

<sup>47</sup> Dan He, ‘The Standards for Substantive Consolidation in Corporate Group Insolvency: A Comparative View’ (2017) 3 *Journal of CUPL* 70; also see Yongliang Wang, Jieguo Huang and Lihong Gao, ‘The legal Practice of Substantive Consolidation in Corporate Group Insoveny’ (2010) 16 *The People’s Judicature* 34.

that have mentioned such an approach.<sup>48</sup> By using this approach, the courts have denied the separateness of companies within a group, and combined all the relevant assets together and made liquidation or restructuring as one legal entity. The legal consequences of the solution are that all the creditors from different member companies are treated as creditors of the whole group, and the debtor-creditor relationships among different members are eliminated. Accordingly, the approach has been criticised. Firstly, the principles of 'limited liability' and independent legal identity under company law are the foundation for doing business between debtors and creditors.<sup>49</sup> Potential consolidation in the circumstance of insolvency would diminish the predictability that creditors would expect to have, and put market transactions in an uncertain condition. Furthermore, denying the legal identity of a company should be done through the formal legal process and not through an insolvency proceeding.<sup>50</sup> Secondly, when all creditors are treated as the group's creditors, the interests of some creditors may be harmed since creditors of companies with fewer liabilities have to share the insolvency losses with the creditors of other group members with a high liability rate.<sup>51</sup> Therefore, with the fact that there is no legal basis for the approach under the Chinese legal system, some scholars argue that it should not be applied.

The supporters of the substantive consolidation approach think that it could improve the efficiency and maximise the value of group insolvency, and it would reduce the insolvency cost and increase the possibility of corporate rescue. Considering the fact that more and more Chinese enterprises are choosing to operate as corporate groups domestically and internationally, consolidation is the right direction for future insolvency law. Although some academic scholars have encouraged it and local judges applied it in practice, the approach has not been mentioned or interpreted by the Supreme Court.

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<sup>48</sup> Dan He (n 47), 72.

<sup>49</sup> Yongjun Li and Dahe Li, 'The Conditions for Starting Restructuring Procedure: The Questions relating to Consolidated Restructuring' (2013) 6 *Journal of Beijing University of BUAA (Social Science Edition)* 48.

<sup>50</sup> *ibid.*

<sup>51</sup> Dan He (n 47), 71.

However, some working papers actually imply the Supreme Court has changed their attitude toward substantive consolidation. In the 2002 official document regarding some issues of enterprise insolvency proceedings, the Supreme Court emphasised the principle of separate insolvency proceedings for separate legal entities.<sup>52</sup> In 2012, substantive consolidation for the issue of corporate group insolvency was one of the official topics for discussion during the conference for interpretation of insolvency law held by the Supreme Court. The discussion made it clear that substantive consolidation is good for improving the efficiency of group insolvency, and legal interpretation and guidance should be provided considering the increasing number of group insolvency cases.<sup>53</sup> Although the interpretation has not been introduced, the Chinese lawmakers have accepted the approach, and the problems now are about when the approach should be triggered and how to apply it in practice.

Since the approach was developed under US case law, the judges have constantly emphasised that the application of substantive consolidation should be cautious. In *Owens Corning*,<sup>54</sup> the court listed five basic principles to guide the courts' determination: (1) entity separateness, which is the fundamental ground rule, should be respected; (2) the approach should be applied to remedy harm caused by the debtors who disregarded corporate separateness; (3) the mere fact that there is benefit to the administration of estate is not enough to invoke the approach; (4) this approach should be rarely invoked as one of last resorts after considering other options; (5) it only can be used defensively and cannot be used offensively for the purpose of altering certain creditors' rights.<sup>55</sup> Furthermore, the UNCITRAL legislative guide also provides that the general principle is to respect the single legal entity, and substantive consolidation could be used in very limited situations.<sup>56</sup> For

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<sup>52</sup> Article 76, Provisions on Some Issues Concerning the Trial of Enterprise Bankruptcy Cases, interpretation No 23 [2002] by the Supreme People's Court.

<sup>53</sup> The Supreme People's Court, 'Symposium Relating to the Certain Interpretation of the Enterprise Bankruptcy Law' (October 2012) < <http://www.court.gov.cn/shenpan-xiangqing-4606> > accessed 26 September 2017

<sup>54</sup> *In re Owens Corning*. 419 F. 3d 195 (3<sup>rd</sup> Cir. 2005).

<sup>55</sup> *ibid*, para 211.

<sup>56</sup> UNCITRAL Legislative Guide on Insolvency Law, Part 3: Treatment of Enterprise

example, there is a high degree of integration of business operations and affairs among group members through control and ownership, and it is difficult to distinguish the assets and liabilities among such group members. However, the concept of substantive consolidation does not exist in Chinese insolvency law, and without official guidance for the application of substantive consolidation, the relevant Chinese courts have to decide whether and how to apply such an approach themselves. One of the results is its overuse. It is possible that judges have decided to use the consolidation approach simply because it would be convenient for them to administer the insolvency proceeding. Additionally, the court-appointed administrator is usually the one to make the application of substantive consolidation to the court, and before making the decision, creditors usually do not have the opportunity to express their opinions on this matter.

#### *Future Suggestion*

Since it may not be possible to have a new enterprise insolvency law in the foreseeable future and there are many uncertainties for corporate group insolvency, having legal guidance addressing the issue of substantive consolidation from the PRC Supreme Court would be an appropriate first step. It would provide the legal basis since such a document has legal effects, and it could provide guidance as detailed as possible; furthermore, it is flexible since the approach is still in the exploration stage; the lawmakers could always make new documents to supplement the original one, if needs be. It has to be clear that the decision to apply the approach should be made based on full consideration of all the relevant factors of individual cases.

Specifically, those principles from US case law mentioned above, and similar ones from the UNCITRAL legislative guide, could be borrowed to clarify the purpose and limited application of substantive consolidation. This approach should only be used in situations where it is difficult or unfair to have separate proceedings, and the purposes are to improve the efficiency of insolvency

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Groups in Insolvency (2012) 1-3.

proceedings, to ensure fairness, and to protect the creditors' interests.<sup>57</sup> Therefore, the courts should be given enough discretionary power to decide whether the approach is appropriate for specific cases.

The most vital issue is to decide the standard for the application of substantive consolidation.<sup>58</sup> According to the limited number of substantive consolidation cases to date, the main reason that judges decided to choose this approach was due to the confusion of legal identity among group members.<sup>59</sup> The confusion could be comprised of different aspects. It could be the confusion of finance.<sup>60</sup> Although each member has an independent finance system, all the financial activities are controlled by the central management company. It could be the confusion of assets, meaning it is difficult to identify separate member company's assets and liabilities. The confusion also could be about the management teams or organisations, such as different members are managed by the same team, or one operation location is shared by different members. Other factors may include lack of decision-making powers in individual members and financial sponsorship among different members.<sup>61</sup>

Since the standard was firstly developed in the field of company law, it is important to clarify its application in the field of insolvency law. It has been suggested that the potential legal interpretation of the substantive consolidation approach could use 'confusion of legal identity' as a central standard. A clear and detailed list of what situations should be counted as constituting the confusion of identity should be given by the Supreme Court. However, it also should be pointed out that confusion of identity should not be the only standard.<sup>62</sup> In certain situations, even when the identities of group members are clear and separate, substantive consolidation may still be

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<sup>57</sup> XinxinWang and Wei Zhou, 'The Establishment of Affiliated Enterprises Consolidated Reorganisation in China' (2012) 25 (2) *Journal of Beijing University of BUAA (Social Science Edition)* 52.

<sup>58</sup> Dan He (n 47) 71-72.

<sup>59</sup> Yangguang, Xu, 'The Discussion of Substantive Consolidation for Corporate Group Insolvency' (2017) 29 (3) *Peking University Law Journal* 818.

<sup>60</sup> *ibid*, 830-833.

<sup>61</sup> *ibid*, 833-835.

<sup>62</sup> *ibid*.

appropriate. As the Chinese consolidation approach and the US common law approach both were court-developed, so references can be made to the US case laws for comprehensive standards for applying substantive consolidation. For example, the courts should consider the cost of separating assets and liabilities among group members. If the process requires a high cost and would harm the creditors' repayment, it may be enough to trigger the substantive consolidation.<sup>63</sup> Additionally, the approach should be considered if it could increase the value of the group's assets or the possibility of restructuring.<sup>64</sup> As the identity consideration is from the point of view of debtors, the interests and expectations of creditors should be considered as well in a situation of group insolvency. The UNCITRAL guide also suggested that creditors must be involved in the substantive consolidation process, so creditors meetings should be held, and relevant plans should be disclosed in detail.<sup>65</sup> Generally, the decision needs comprehensive consideration of all the circumstances of each case.

## **7.4 Corporate Group Insolvency with International Elements in China**

### **7.4.1 International Trends**

As far as the domestic insolvency system is concerned, only a few countries have introduced formal regulations for governing corporate group insolvency. Internationally, because of the complexities of group insolvency compared with single entity issue, the development is more disappointing. As UNCITRAL observed "there is often a clear tension between the traditional separate legal entity approach to cooperate regulation and its implications for insolvency and the facilitation of insolvency proceedings concerning a group or part of a group

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<sup>63</sup> Su Bei, 'Bankruptcy Law's Special Attention to Corporate Group' (2007) *China Law* 109.

<sup>64</sup> *ibid.*

<sup>65</sup> UNCITRAL Legislative Guide on Insolvency Law: Part three: Treatment of Enterprise Groups in Insolvency, 65-67.

in a cross-border situation in a manner that would enable the goal of maximising value for the benefit of all creditors to be achieved”.<sup>66</sup> Generally, the principle of universalism has been recognised as the correct direction, and a milder approach developed accordingly.<sup>67</sup> Both the UNCITRAL Working Group and the Recast European Regulation agreed encouraging coordination and cooperation among different proceedings affecting different group members would be the most practical method of facilitating group insolvency.

### *European Regulation*

The approach was formally legislated by the newly recast European Regulation on Insolvency Proceedings. After years of discussions and reviews, a new chapter focusing on “Insolvency Proceedings of Members of a Group of Companies” was developed.<sup>68</sup> Instead of finding a “one for all” solution, the new chapter aims to improve the efficiency of group insolvency through encouraging cooperation and communication among the practitioners and courts involved in the insolvency of the different members of the group, and through coordination among different proceedings when it is possible.<sup>69</sup> It has to say the chapter was a compromise in order to achieve a politically acceptable solution among member states; furthermore, it also reaffirms the principle of respecting the separate personality of members of a group.<sup>70</sup> Therefore, the approaches in the new chapter are not all mandatory.

Cooperation and communication is the first mechanism of the two pillars approach, which states that when there are two or more members from one corporate group subject to insolvency, relevant courts and practitioners may

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<sup>66</sup> UNCITRAL Legislative Guide on Insolvency Law, Part 3: Treatment of Enterprise Groups in Insolvency (2012) 85 <<http://www.uncitral.org/pdf/english/texts/insolven/Leg-Guide-insol-Part3-ebook-E.pdf>> accessed 20 September 2017.

<sup>67</sup> Irit Mevorach, Cross-border Insolvency of Enterprise Groups: The Choice of Law Challenge (2014) 9 (1) *Brooklyn Journal of Corporate, Financial and Commercial Law* 226.

<sup>68</sup> Regulation (EU) 2015/848 of the European Parliament and of the Council of 20 May 2015 on insolvency proceedings (‘New Recast EIR 2015’).

<sup>69</sup> Robert Van Galen, ‘The Recast Insolvency Regulation and Groups of Companies’ (2015) *ERA Forum* 241.

<sup>70</sup> Preamble 54, New Recast EIR 2015.

be obliged to cooperate and communicate to facilitate the effective administration of those proceedings.<sup>71</sup> The cooperation could be among different parties, such as between insolvency proceedings or between practitioners; and it may also take any form, such as agreement or protocol. Those new provisions on cooperation offer a legal framework to allow relevant parties from different members' proceedings to communicate. More importantly, it also gives parties the flexibility to decide the most appropriate form of cooperation based on the circumstances of the case. Such cooperation could be very beneficial if the group is highly integrated and the relationship among subsidiaries is very close as it is possible to maximise the value of involved assets for creditors, or to facilitate the restructuring of relevant members of the group, or the reorganisation of the whole group.

The second pillar is the group coordination proceedings. According to Section 2 of Chapter V, group coordination proceedings may be requested by an insolvency practitioner before any court involved in insolvency proceedings of any member of the group.<sup>72</sup> Such a proceeding requires a coordination court, a coordinator and a group coordination plan. The court first seized should have the jurisdiction over the coordination proceeding, and the court can be changed if two-thirds of the majority of practitioners involved agree another more appropriate one.<sup>73</sup> The proposed coordination plan is to recommend a comprehensive set of measures appropriate to an integrated approach to the resolution of the group members' insolvencies.<sup>74</sup> Participation in the coordination plan is voluntary, so each practitioner has the right to decide whether to join and follow the coordination proceeding, and it is also possible to join the plan at a later stage even if it was objected to at the beginning.<sup>75</sup> The adoption of the coordination approach is to avoid the inherent difficulties of group insolvency cases, and ensure consistency across the proceedings of all the members of the group. It could improve the efficiency of all proceedings

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<sup>71</sup> Article 56, New Recast EIR 2015.

<sup>72</sup> Article 61, New Recast EIR 2015.

<sup>73</sup> Article 62, 66 (1), New Recast EIR 2015.

<sup>74</sup> Article 70, New Recast EIR 2015.

<sup>75</sup> Article 66 (3), New Recast EIR 2015.

by saving time and costs since the coordinator would reduce the repetition, mediate the conflicts among different parties, and provide relevant information to all practitioners involved.

Overall, cooperation and coordination may contribute to increasing efficiency and legal certainty of group insolvency in practice. The two mechanisms are trying to find the middle ground between the traditional principle of a separate entity and universalism approach for multinational insolvency; basically, the approaches enacted reflect the principles of universalism, but leave room for practitioners or courts to decide whether to join the universal solution. However, it has been argued that the high level of flexibility under the new approach could lead to more uncertainties and unpredictable issues in the process.<sup>76</sup> Practitioners are not obliged to cooperate or join the coordination plan if they are not happy with the proposed plan, or there is a conflict of interests among different members of a group, and such conflicts are not uncommon.<sup>77</sup> The voluntary nature of the law probably means that it will not be much used in practice, as noted by Weiss: that coordination can turn into a lame duck because of this reason.<sup>78</sup>

Addressing the issues of group insolvency is a positive step of the European regulation. Since the recast has only been introduced less than two years ago, the benefits or drawbacks remain to be observed.

#### *UNCITRAL Model Law*

Similar to the European system, the UNCITRAL Working Group has further developed the recommendations listed under the legislative guide for the purpose of reaching general consensus among jurisdictions for coordination and cooperation. According to the official papers from the Working Group, it

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<sup>76</sup> Bader Juma Almaskari 'Towards Legal Certainty: European Cross-Border Insolvency Law and Multinational Corporate Groups' (PhD Thesis, University of Leicester 2017).

<sup>77</sup> Robert Van Galen (n 69), 250.

<sup>78</sup> Michael Weiss, 'Bridge over Troubled Water: The Revised Insolvency Regulation' (2015) 24 *International Insolvency Review* 192, 212.

should be a coordinated insolvency solution encompassing all the relevant members, if one enterprise group is in financial difficulty.<sup>79</sup> The solution also should be a flexible concept, taking into consideration the differences in the groups' structure, business model and the level of integration between the members.<sup>80</sup> Flexibility would be more essential in the Model Law context, as it will deal with more jurisdictions with various political and legal systems. Regarding the specific solutions, the Working Group recommends the similar principles as the European approach, saying that cooperation and coordination are required to have efficient group insolvency.<sup>81</sup> The level of cooperation could be different depending on the circumstances of a specific group. It may require cooperation among representatives from different members' proceedings to negotiate and develop the best solution for the group, and such cooperation should be extended to the maximum.<sup>82</sup>

While respecting the separateness of group members, UNCITRAL also recognised the benefits of one proceeding taking a lead role in a group case, as it would coordinate other proceedings. Hence, one of the insolvency representatives or courts taking the coordinating role could be one form of cooperation. Another level of coordination would be through a coordination proceeding, and the essential elements would be the proposed coordination plan and coordinator. The plan is open to both insolvent and solvent members to participate voluntarily. Additionally, another principle states that each member's proceeding would have the jurisdiction to deal with the group plan based on applicable domestic law, and the purpose is to preserve the rights of local creditors and other stakeholders.<sup>83</sup> Based on the solutions from the two international regimes, it seems that cooperation and coordination would be the best possible solution for now. There is no doubt that such a system

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<sup>79</sup> Working Group V, 'Facilitating the Cross-border Insolvency of Multinational Enterprise Groups: Draft Legislative Provisions' Working paper A/CN.9/WG.V/WP.146. Principle 1.

<sup>80</sup> *ibid.*

<sup>81</sup> *ibid.*, principle 2.

<sup>82</sup> *ibid.*; see also Recommendation 250, Part 3 of UNCITRAL Legislative Guide on Insolvency Law.

<sup>83</sup> *ibid.*, principle 6, 7.

could improve the efficiency and respective interests of different parties, but some practical concerns, such as how to ensure a high participation rate or which would be the most appropriate coordination court, require further guidance.

#### **7.4.2 Possible Developments in Chinese Law**

For corporate group insolvencies with international elements, Chinese courts should follow the current international trend to encourage cooperation with other foreign proceedings when it is appropriate. Firstly, since foreign enterprises are opening more branches in China and Chinese groups are making investment internationally, Chinese courts may face an increasing number of group insolvencies, and currently, cooperation could be the best solution. For instance, if there is a foreign coordination proceeding for a corporate group and one of its subsidiary's insolvency proceeding is in China, the Chinese court should consider participating in the coordination proceeding if the outcome would be beneficial to Chinese creditors. Chinese courts would expect the same cooperation from relevant foreign proceedings in similar situations. Effective solutions to international problems always require the willingness to work together with relevant parties.

Secondly, current international solutions are on a voluntary basis, which could be more acceptable to Chinese legislators. It has been discussed that the UNCITRAL Working Group adopted a more practical 'modified universalism' to solve corporate group insolvency.<sup>84</sup> One example is that the concept of 'group COMI' was abandoned since it is difficult to reach a well-accepted definition.<sup>85</sup> So the current UNCITRAL position reflects a less ambitious approach that respects the separateness of legal entities governed by different insolvency proceedings. Legal guidance encouraging a voluntary approach from the Supreme Court could be passed, and the judges would

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<sup>84</sup> Simona Di Sano, 'The Third Road to Deal with the Insolvency of Multinational Enterprise Groups' (2011) *Journal of International Banking Law and Regulation* 15.

<sup>85</sup> Report of Working Group V (Insolvency Law) on the work of its thirty-fifth session, <<https://documents-ddsny.un.org/doc/UNDOC/GEN/V08/585/80/PDF/V0858580.pdf?OpenElement>> accessed 10 August 2017.

have the power to decide whether to cooperate with foreign proceedings or join the coordination proceedings. As with domestic group insolvency, the facts of different group insolvency cases could vary, so the judges have to consider all the relevant factors to make a decision.

The more interesting issue is the regional corporate group insolvency issue between mainland China and Hong Kong. The special relationship between these two jurisdictions requires a special solution for the issue as the voluntary approach concerning international issues may be not suitable for two areas with such an intimate economic connection. For instance, one corporate group which operates a business in both jurisdictions and with several members has started insolvency proceedings. The question is whether there is an effective approach to coordinating all those relevant proceedings. Following the discussion in the last chapter, which suggested that the concept of COMI could be used to solve recognition issues between the mainland and Hong Kong, it is argued that the concept also could be used for corporate group insolvency between the two jurisdictions.

The concept “group COMI” could be introduced for corporate group issues between mainland China and Hong Kong. The group COMI for a corporate group should be the jurisdiction where its management headquarters or head office is located. Group COMI would help the court decide which member of the group is in the main position, and the court in the location of such a dominant member would have the jurisdiction to open the main proceeding for the purpose of coordinating all the members’ proceedings. The general factors to consider for deciding the group COMI include where the major group’s business plans are made, where financial operations are carried out and where the management decisions that would influence most of the members’ business activities are made. The administrator in this proceeding should be the coordinator as well. The proceedings in the non-group COMI jurisdictions should be allowed to decide whether to join the coordination plan proposed by the coordinator. Since the issue of corporate group insolvency has not been addressed by the authorities of either jurisdiction, this hypothetical approach aims to provide a possible direction for solving issues between mainland

China and its special administrative regions.

## 7.5 Conclusion

An effective legal regime to deal with the complexities of corporate group insolvencies remains a major unresolved issue at both domestic and international levels, and one of the main reasons is the inherent conflict between the principle of the independence of separate legal entities and consolidated insolvency proceedings. At the domestic level, ignoring the separateness of group members may be necessary in certain cases in order to maximise the value of the insolvent group for distribution, or achieve better reorganisation plans, but this approach has to be applied with limitations. For the insolvency of multinational corporate groups, the principle of cooperation and communication, encouraged by international insolvency regimes, seems to be the practical solution as it is consistent with the modified universalism for achieving a global result to the maximum extent possible.<sup>86</sup> As for the Chinese insolvency system, it is important to address the corporate group issues because of the increasing number of state-owned corporate groups and multinational corporate groups involving Chinese parties. Since the Chinese corporate insolvency system is relatively new, especially the reorganisation system which was just introduced in the 2007 insolvency law, it is suggested that the Supreme Court could issue legal recommendations on this subject to supplement the current insolvency system. It should formalise the substantive consolidation approach with clear guidance, and an international cooperation procedure for multinational cases. Additionally, addressing corporate groups insolvency issues would also be a driving force for the development of other legislation for corporate groups.

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<sup>86</sup> Irit Mevorach, 'Towards a Consensus on the Treatment of Multinational Enterprise Groups in Insolvency' (2010) 18 *Cardozo J. Int'l & Comp. L.* 359, 383.

## Chapter 8 Conclusion

This thesis has carried out an in-depth examination and discussion of the UNCITRAL Model Law on Cross-Border Insolvency and its possible implications for reforming Chinese national and interregional insolvency regimes. This chapter will provide the conclusion to the thesis by first highlighting the main findings that have emerged from the different chapters and the answers to the main research questions. Potential implications will be summarised in the second part. The third part will discuss the limitations of this study and possible directions for future researchers.

### 8.1 Findings and Reflection on Research Questions

#### *Question1: The Nature of Cross-border Insolvency*

Chapter 2 explored the complexities and difficulties connected to cross-border insolvency issues. The existence of cross-border insolvency issues has been caused by the rapid development of globalisation. While applying multinational corporate structure is necessary for seeking international competitive advantages, the failure of those companies has raised global difficulties. Essentially, the fundamental insolvency issues are magnified by the fact that the presence of assets, claims and creditors are located in more one jurisdiction. Although solving cross-border insolvency will face the same issues as resolving national insolvency, which is to fairly balance various types of creditors' interests with a limited amount of debtor's assets, cross-border insolvency law is not merely an extension of national insolvency law.<sup>1</sup> Due to the multinational nature of the issue, the solution for cross-border insolvency must also deal with issues that are caused by the divergence of various national insolvency systems.<sup>2</sup> Hence, three main conflicts of law issues are relevant, which are jurisdiction, choice-of-law, and recognition of foreign

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<sup>1</sup> S Block-Lieb and T Halliday, 'Harmonization and Modernisation in UNCITRAL Legislative Guide on Insolvency Law' (2006-2007) 42 *Texas International Law Journal* 475, 511-512.

<sup>2</sup> *ibid*; UNCITRAL Legislative Guide on Insolvency Law 2004, 19-20.

judgments.

The answers are related to two main theories: universalism and territorialism. Over the years, universalism has won the long-running debate between universalism and territorialism and has been recognised and applied as the fundamental principle of cross-border insolvency law.<sup>3</sup> A single insolvency proceeding controlling debtors assets that are located all around the world reflects the concept of the undivided entirety of property. This approach is economically efficient since it reduces the collection costs and avoids the dramatic differences in national laws. However, there is always a struggle between the ideal principle and the reality, and the application of universalism had to make practical compromises. The invention of “modified universalism” reflects those compromises, which allows the existence of territorial/secondary proceedings while sharing the view of one main proceeding in the debtor’s home country playing a controlling role for international cases. Some argued that this feature could lead to a major departure from the original objectives of universalism. This study concludes that having secondary proceedings is necessary for an international regime for cross-border insolvency. The main purpose of this is to balance the local interests and the principle of universality, which means that such an approach could be willingly accepted by more countries.

Furthermore, if only one jurisdiction could open insolvency proceedings against a debtor, it is possible that there would be an intensive fight over the centre of main interest (COMI) location among relevant countries, so territorial proceedings would reduce those COMI competitions. The modified universalism approach also emphasises the importance of cooperation and communication among different insolvency proceedings, which would be the main principle to achieve the aim of universality. The fact that both the European Regulation and the UNCITRAL Model Law system have adopted main and non-main proceeding approaches provides support to the feasibility of modified universalism, and cooperation and communication also have been

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<sup>3</sup> John AE Pottow, ‘Greed and Pride in International Bankruptcy: The Problems of and Proposed Solutions to Local Interests’ (2006) 104 *Michigan Law Review* 1899.

included as one duty of court under both regimes.

*Question 2: The Features and Effectiveness of the UNCITRAL Model Law on Cross-Border Insolvency*

Chapter 3 examined the application of the UNCITRAL Model Law in detail. Having realised that universalism is the fundamental principle, great efforts have been taken by different international organisations to develop a convergent regime for solving cross-border insolvency. Currently, the UNCITRAL Model Law is the first regime that has been widely accepted and adopted internationally. The nature of the Model Law is a set of recommendations to help countries establish a harmonised, effective and fair cross-border insolvency law under their own domestic insolvency law.<sup>4</sup> The adoption is voluntary and enacting countries are allowed to make modifications. Without a regional arrangement like the European Union and considering the diversity of domestic insolvency regimes, a flexible approach is necessary and appropriate. First, it assists the extensive application among different countries, as the law is intended to be used as an international tool. Second, the flexibility and broad application could meet the world's urgent need for an effective cross-border insolvency system facing the rapid development of the multinational business. The basis of the Model Law focuses on simplifying procedures for recognition, relief and cooperation and communication between courts and insolvency representatives.<sup>5</sup>

One of the main purposes of the Model Law is to facilitate recognition of qualified foreign proceedings, and it uses the jurisdictional concepts, COMI, and establishment, to decide recognition of foreign proceedings as main or non-main proceedings. The concept of the centre of main interests is a rebuttable presumption. As the law did not provide a clear definition of COMI, how to rebut this presumption of incorporated location has caused many issues. The incoherent interpretation of the meaning of COMI is one main

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<sup>4</sup> UNCITRAL Model Law on Cross-Border Insolvency with Guide to Enactment and Interpretation, 19.

<sup>5</sup> *ibid*, 26-27.

issue. The study found that although both the European insolvency regime and the Model Law adopted the COMI concept, its function under each regime is different. While the European Regulation is a jurisdiction-dominant procedure, deciding COMI is essential because it is related to basic issues including appropriate jurisdiction, applicable law and automatic recognition. Under the Model Law, the function is less significant, and as the US case law suggested, the interpretation of COMI should reflect the international nature of the law and apply "the principal place of business" test to make a comprehensive judgment based on all the relevant information.

The Model Law has taken a neutral position on the matter of choice-of-law due to various insolvency systems from state to state. Instead, the effects of recognition are regulated by different types of relief. One enacting court could grant provisional relief before recognition or relief upon recognition, and automatic reliefs are only available to the recognition of foreign main proceedings. The different understandings among different enacting countries about the discretionary relief under article 21 of the Model Law have caused uncertainty, which is about whether an enacting court could grant relief based on the foreign law of the jurisdiction where the insolvency proceeding was opened. While the US case law suggested foreign laws could be applied under right circumstances, the UK judges took the opposite approach. This study agreed with the US approach because the language and explanation of the Model Law do not rule out the possibility of applying the foreign law and it is consistent with the principle of universalism.

Another main feature of the law which is emphasised is that of cooperation among recognising courts, foreign courts and foreign representatives. Direct communication is encouraged when it is needed, which would avoid traditional procedures such as diplomatic channels or other time-consuming procedures. The duty to cooperate under Articles 25–27 could be essential to the success of the Model Law, as chapter 2 discussed, as cooperation and communication is the solution that could reduce the territorial influences under modified universalism and the key to achieving outcomes of universalism.

The flexibility of the Model Law that allows enacting countries to make

modifications is a double-edged arrow. On the one hand, this feature could guarantee its acceptance rate among states. It is expected that enacting countries should only make necessary changes and promote international uniformity of the law. This type of modification is only to make sure the Model Law could fit into the domestic legal system. For example, article 21 (2) ensures local creditors' interests are protected, and the US chapter 15 changed its wording from "adequately protected" to "sufficiently protected." Such a change was only to make sure that the terminology is coherent under its bankruptcy code.

On the other hand, it could give states the opportunity to alter certain articles for their benefits, which could lead to the incoherence of the application of the Model Law and eventual departure from the principle of universalism. For instance, public policy is the main reason to refuse recognition under the Model Law, which has been interpreted by the UNCITRAL Working Group in a restricted manner and is expected to be applied in exceptional cases; additionally, the meaning of public policy in the international context should be understood more restrictively than the meaning under domestic law. However, some states have removed the word "manifestly" or changed the language, which increases the possibility that this article would be used as an easy excuse to refuse recognition. This study concluded that the Model Law was designed to work internationally, and the system has provided enough safeguards to protect local interests. While extra protections and alterations, especially for countries without comprehensive insolvency systems, are necessary, a balance has to be found between achieving international effects and protecting local interests.

### *China's Cross-border Insolvency Regimes and the UNCITRAL Model Law*

#### *Question 3: Mainland China*

The development of the domestic insolvency system of China reflects the economic reform, and traditional Chinese thinking and political factors have a

great influence on Chinese insolvency cultures.<sup>6</sup> Insolvency of non-stated owned enterprises was not regulated until the last two decades because state-owned enterprises used to be the main form in the Chinese economic system and the insolvency of those businesses was directly related to governmental policies and orders. To support the national economic reform and participate in international business, the first modern insolvency law, the Enterprise Bankruptcy Law (EBL), was passed in 2006, and this regulates all types of corporate insolvency. The new insolvency law was a big improvement in the Chinese insolvency system. It brought about the adoption of more advanced arrangements that were borrowed from western insolvency systems, such as modern priority rules for distribution. More importantly, it emphasised the culture of corporate rescue by adopting reorganisation proceedings and introduced the concept of international insolvency.

However, some factors from the planned economy system have been inherited in the new law, and involvement of government is the most significant one. Maintaining social stability and protecting employees are the two main reasons that the government would interfere in insolvency proceedings. This reflects the fact that although some state-owned enterprises have been privatised due to the economic reform, state-owned capitals still have a significant influence on those "private" companies. Therefore, the new law provides legal justification and leaves room for government interference. It cannot be denied that government involvement has its advantages in supporting the transition process, but the basic line is that the independence of the court in insolvency proceedings shall be protected.

Article 5 of the EBL is the only one article addressing issues of cross-border insolvency. Because of the influences from international organisations like the World Trade Organization (WTO) and the World Bank, the process of making this article was influenced by the principle of universalism. The first part of the article stipulates the extraterritorial effects of Chinese insolvency proceedings, and the second part provides regulations for recognition of foreign insolvency

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<sup>6</sup> Enoch K. Beraho and Richard Elisu, 'Influence of Country Culture on Bankruptcy and Insolvency Legal Reform Management' (2010) 14(2) *International Journal of Management & Information Systems* 39, 46-47.

proceedings, which includes three main elements: international agreements or treaties; the principle of reciprocity; and public policy. In practice, the application of this article is very limited. First, only a few jurisdictions have established mutual civil and commercial judicial assistance agreements with China. Also, Chinese courts still apply restrictive and passive reciprocity rules for granting recognition of foreign judgments. Furthermore, even one foreign judgment could meet one of two recognition conditions. The reservation of public policy is another obstacle to pass. Public policy here includes the basic principle of Chinese laws, the sovereignty, public interests and local creditor's rights, and such broad coverage has offered Chinese courts discretionary power to refuse recognition. Therefore, recognition of foreign insolvency proceedings under this article could be very difficult. Although this article is a milestone in Chinese insolvency history, its insufficient application has been criticised and there have been calls for reform. Especially since a Chinese case (*Zhejiang Topoint*) was recognised based on Chapter 15 in the US, the advantages of the UNCITRAL Model Law regime have received more attention and discussion in China.

Although article 5 still reflects territorial features, it was a good start towards accepting the principle of universalism. According to the comparative analysis, this study argued that there are legal principles under relevant Chinese laws sharing similar features with the UNCITRAL Model Law, which could provide a legal foundation for future adoption. Regarding the jurisdiction issues, the debtor's domicile is the basic rule. The General Principle of Civil Law and its interpretation further provides that debtor's domicile means the location of his major business operation, and if the place of major operation could not be found, the court of its registered location shall have the jurisdiction. This civil law interpretation mirrors the general application of the COMI concept under the Model Law. However, Civil Procedural Law also gives Chinese courts broad power to claim jurisdiction over foreign companies in China. With the broad jurisdiction rule, if China happens to be the location of COMI, a Chinese proceeding could be recognised as the foreign main proceeding in an enacting state, and international effect could be achieved. But if the foreign company only has an establishment in China, the Chinese proceeding is only a non-

main proceeding and has limited effects. If the Chinese proceeding wished to participate in international insolvency, the jurisdictional rules under Chinese law should distinguish main and non-main proceedings.

#### *Question 4: Hong Kong*

Chapter 5 focused on the analysis of Hong Kong's insolvency system. Because of political history, the insolvency system of Hong Kong has been heavily influenced by English statutory insolvency law and common law. The rules for corporate insolvency are regulated by the Companies Ordinance. As one of the most important financial centres in the world, it is surprising that there is no proper statutory corporate rescue regulation in Hong Kong. Regarding cross-border insolvency law, common law approaches are the main source in Hong Kong. Hong Kong judges have a good history and willingness to cooperate and assist foreign insolvency proceedings, and often make references to the principles of universalism or modified universalism. The principle for recognising foreign insolvency proceedings is related to the issue of jurisdiction. However, since there is no statutory basis for recognition, foreign representatives usually open separate insolvency proceedings in Hong Kong based on the statutory basis of winding-up unregistered companies.

Case law has developed three core requirements to decide the jurisdiction of Hong Kong courts over foreign unregistered companies. Given the developments of recent case law, the traditional presence of assets test has been replaced, and such assets can satisfy the first core requirement regarding sufficient connection with Hong Kong. The second requirement is that the local winding-up proceeding would benefit those applying for it. The third requirement, which is that the court must be able to exercise jurisdiction over one or more persons interested in the distribution, can be omitted if the first two have been sufficiently satisfied and Hong Kong is central to the company's principal activities. Furthermore, it is noticeable that Hong Kong judges take a flexible approach interpreting those requirements, and holding the three requirements are only guidance for the court to exercise at its

discretion, so judgment should be made based on the actual evidence presented in a particular case. As a result, the power of winding-up unregistered companies was extended to cover off-shore companies (*Yung Kee*). This new development has the advantage of identifying the most appropriate forum for insolvency proceeding.

Although Hong Kong judges have expressed their support of the UNCITRAL Model Law and its principles, the government still applies a 'wait-and-see' attitude toward the reform of cross-border insolvency law. However, through the comparative analysis, it is concluded that Hong Kong's common law approach for cross-border insolvency could achieve similar results as the Model Law. The newly-developed jurisdiction rule adopted by Hong Kong judges was the same with the concept of COMI. In short, the purpose of treating the three core requirements as discretionary guidance is to encourage judges to find the real business centre of the debtor and the appropriate insolvency place. Although Hong Kong courts have not officially applied the concept of COMI in case law, the recent Singaporean case, which adopted COMI analysis under common law for the first time, has provided a timely authority. Furthermore, modified universalism has been accepted by judges in Hong Kong, so it could be expected that they are willing to grant discretionary reliefs to cooperate and assist foreign proceedings if it is required. As a statutory cross-border insolvency law is still pending in Hong Kong, this court-developed approach is necessary and effective.

#### *Question 5: Interregional Issues between the Mainland and Hong Kong*

The "One Country, Two Systems" concept has established a special relationship between mainland China and Hong Kong. The Basic Law legalised the concept and vested Hong Kong with a high degree of autonomy, which means the Hong Kong Special Administrative Region will have independent executive, legislative and judicial powers. At the same time, after the introduction of the Closer Economic Partnership Arrangement, an interregional free market has been established, which further encourages the economic cooperation and exchange between the two regions. After the

political transition, China is a country with various jurisdictions, including the civil law system and the common law regime. While the basic legal characteristics of the mixed legal system have been guaranteed by the Basic Law, supplementary regulations are missing for solving specific legal issues between the two regions. In particular, an interregional cross-border insolvency system is urgently needed. As the practical case showed, because of the tradition of government involvement in insolvency proceedings and local protectionism in the mainland, it is more difficult for Hong Kong parties to participate in the mainland insolvency proceedings than joining other foreign proceedings. Without a predictable and sufficient problem-solving system, participants of the economic interaction between two regions cannot evaluate possible risks in a transparent manner, which could jeopardise the economic stability in the region.

This thesis argued that solving recognition issues would be a good start for solving the interregional insolvency issues in China, as the issue of judgment recognition has had previous legal development and foundation based on a bilateral agreement. Extending the current arrangement to cover interregional insolvency issues is not practical. Both jurisdictions agreed that solving judicial recognition issues between two areas should take place in small steps, so the scope of the arrangement is limited. Additionally, it was developed based on similar international conventions, which did not reflect regional factors. Without clear explanation on certain legal issues, such as the criteria for final judgment and refusing recognition, uncertainties still exist. Therefore, the suitable solution is to use the current arrangement as a starting point and design a special regional insolvency agreement focusing on recognition and judicial assistance issues. It is suggested that the proposed agreement should be developed based on the UNCITRAL Model Law. The main reason for this is that the Model Law has solved a similar issue, which deals with insolvency recognition among different legal jurisdictions. Moreover, the close political and economic relationship could provide better support to the regime based on COMI and cooperation.

## 8.2 Implications for the Reform of the Chinese Insolvency System

Based on the discussions and findings of this study, there is no doubt that the Chinese cross-border insolvency system needs to be updated. It is suggested that the guiding principle for future reform should be the principle of universalism, which is the essential concept accepted globally. Applying universalism will be the inevitable trend, as convergence and harmonisation are the mainstream for solving international issues.<sup>7</sup> As the concerns of judicial sovereignty and local interests are unavoidable, modified universalism is pragmatic. Whether a country needs a sufficient cross-border insolvency law is related to its economic strength. Since China plays a more significant role internationally, it is just a matter of time before Chinese legislators would consider applying the well-recognised principle to deal with its international issues. Furthermore, the principle of universality could also be the solution for interregional insolvency issues between the mainland and its SARs.

The Supreme People's Court is considering the introduction of new interpretations to address insolvency cases with international elements, including cross-border insolvency.<sup>8</sup> This would be a great opportunity to introduce detailed guidance under the present Article 5 by reference to the UNCITRAL Model Law and the concept of COMI, which should include issues like jurisdictions of court, application of relevant laws and assistance and recognition concerning foreign insolvency proceedings. As chapter 4 suggested, some of those issues have been addressed but separated under Chinese civil laws and other commercial laws. For example, relevant civil law principles for jurisdiction rules in China share a similar concept with COMI. This means that the Chinese system has the potential to accommodate the UNCITRAL Model Law, and requires a comprehensive system to unify those insolvency-related rules.

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<sup>7</sup> Hwa-Jin Kim, 'Taking International Soft Law Seriously: Its Implications for Global Convergence in Corporate Governance' (2001) 1 (1) *Journal of Korean Law* 1.

<sup>8</sup> Xinxin Wang, Yangguang Xu and Alan CW Tang, "PRC Enterprise Bankruptcy Law and Practice in China: 2007 to a Record-Breaking 2017" (2018) INSOL International-Special Report.

Another area that the Supreme Court could address would be corporate group insolvency issues. As chapter 7 discussed, currently no relevant laws are regulating corporate groups' issues in China. A court-developed approach such as substantive consolidation has caused discussions and arguments in academic society and the Supreme Court. As effort at both domestic and international levels are being put into this area, detailed guidance from the Supreme People's Court would be a necessary supplement to the current insolvency law.

Furthermore, an official interpretation acknowledging the Model Law would have more significant influence on Hong Kong. Primarily, it would provide the legal foundation for solving the insolvency issues between the mainland and Hong Kong. A bilateral agreement based on the Model Law regime would provide the appropriate solution. More importantly, it would potentially give Hong Kong an opportunity to adopt the Model Law finally. In deciding whether to enact the Model Law into Hong Kong's insolvency system, the local government is closely monitoring the attitudes of its major trading partners, including the mainland and Singapore.<sup>9</sup> As Singapore has adopted the law in 2017 to promote its position as a financial centre further, support from the mainland would be a major push for adoption.

Another benefit of a detailed cross-border insolvency system is to reduce the government involvement in insolvency cases. Although government involvement has a long history and in fact has benefits in certain cases, improper interventions should be limited. Especially for international cases, as cooperation among proceedings is encouraged, excessive government intervention would cause a negative influence on the communication. Therefore there should be a clear demarcation between government administrative powers and judicial powers. A well-established and effective insolvency system will emphasise the importance of the legal system and

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<sup>9</sup> Bills Committee on the Companies (Winding Up and Miscellaneous Provisions) (Amendment) Bill 2015: Summary of Views of Submissions and Government's Responses, CB (1)481/15V16 (04) (2016), Government's Responses No.59 <<http://www.legco.gov.hk/yr15-16/english/bc/bc01/papers/bc0120160125cb1-481-4-e.pdf>> accessed 01 January 2018.

reduce certain concerns that local governments may have.

### **8.3 Limitations and Areas of Further Research**

Although this study was carefully conducted, there were some unavoidable limitations. The first of these confines was the limited relevant primary materials on mainland China. There is a notable lack of academic work in Chinese cross-border insolvency law as this legal area is a relatively new area. Besides, the case reporting system in China is inadequate, so reliance had to be placed on secondary materials which included newspapers, journal articles and relevant reports from international organisations such as the International Monetary Fund (IMF) and the World Bank. Although those secondary sources are very insightful, it cannot be denied that they bring the possibility of biased reports.

The second limitation is the scope of the study relating to enacting countries of the UNCITRAL Model Law on Cross-Border Insolvency Law. As was explained at the beginning, the Model Law cases from the US and the UK are used to evaluate the effectiveness of the law. Since there are more than 40 jurisdictions that have adopted the law, reviewing and examining its application in more jurisdictions would give more insightful and justified results. Although decisions from the two developed jurisdictions are frequently followed or referenced by other countries, the practical application of a soft law could still be various under different legal and economic jurisdictions. Especially in those less-developed jurisdictions that do not have a well-established domestic insolvency system but have adopted the Model Law, their experiences would be beneficial to other developing countries. Therefore, for future empirical researchers that cover more cases from different enacting countries it would be necessary to have a comprehensive evaluation of the functions of the Model Law.

Regarding the study of the Chinese insolvency system, this study was mainly about procedural law issues, and it is planned that future studies would focus on substantial law matters related to cross-border insolvency issues. Moreover, the interregional research was only focused on the Hong Kong

Special Administrative Region. Since Hong Kong is one of the most influential jurisdictions with regards to economic power and legal stability, the study intended to use it as an example to discuss interregional insolvency issues under the Chinese "one country, two systems" regime, which could provide a reference to other special regions including Macao and Taiwan. However, legal regimes among those regions could be different; hence, future studies are required to undertake detailed discussions on cross-border insolvency regimes in those regions of China.

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