KEY POINTS

- Dealing with the onshore debt obligations and offshore creditor involvement in the onshore restructuring options presents new challenges for PRC financial restructurings.
- The offshore financial creditors' debts are likely to be structurally subordinated and the offshore financial creditors face various challenges in seeking to implement a restructuring solution or extracting value onshore.
- Chinese courts are prepared to recognise the judgments of foreign courts made in insolvency proceedings only when certain conditions are met.

Feature

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Extracting value for offshore creditors either side of the Chinese wall: restructuring PRC financing structures

In this article, the authors summarise the key techniques and challenges, from the perspective of the offshore financial creditors, in seeking to implement a restructuring solution for Chinese financing structures.

INTRODUCTION

The growth prospects and economic stability of the Asia-Pacific region are being threatened by a number of complex economic factors. However caused, there is a real prospect of an increase in financial restructurings of issuers and borrowers in China and the Asia-Pacific region. Asian corporate debt levels have dramatically increased in recent years from c. 80% of GDP in 2007 to c. 125% as at February 2016 as the region's borrowers have taken advantage of record-low interest rates and global investors' search for higher-yielding assets. In 2015 alone, Chinese non-financial companies took on an additional US$1.2trn of debt, which lifted the corporate debt to record-high levels.

To introduce and explain the particular challenges associated with the restructuring of Chinese financing structures, this article contains a brief overview of a typical "offshore/onshore" Chinese financing structure and the issues associated with such a structure. It summarises the key techniques and challenges, from the perspective of the offshore financial creditors, in seeking to implement a restructuring solution, particularly given the involvement of multiple jurisdictions and the absence of formal inter-jurisdictional co-operation protocols.

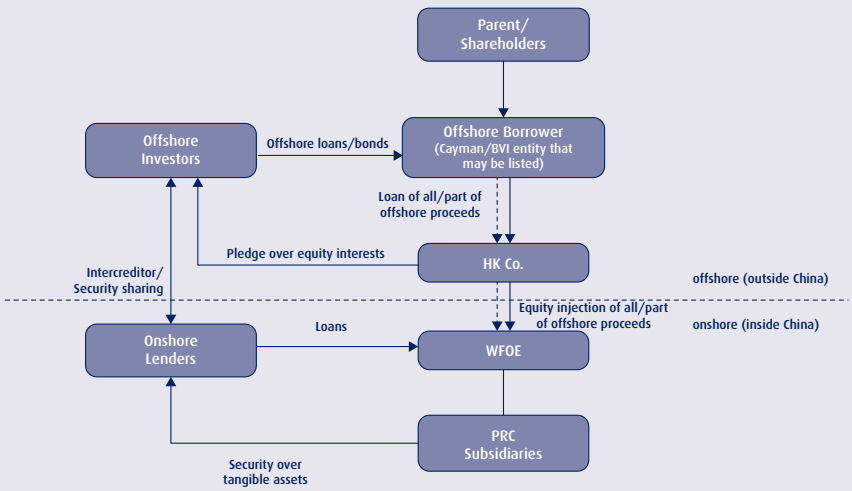
TYPICAL CHINESE OFFSHORE AND ONSHORE FINANCING STRUCTURES

Foreign lending into China is subject to various regulations (including restrictions and registration/filing requirements), with different rules applicable to foreign currency loans and to RMB loans. Pursuant to the Chinese foreign debt administration regime, foreign debts are subject to a level of regulation that is not applicable to domestic debts.

As a result of these regulations, Chinese borrowers use a variety of offshore financing structures to access foreign debt capital. A typical lending structure used by a Chinese company involves an offshore borrower, often incorporated in a tax-efficient jurisdiction, such as the British Virgin Islands (BVI) or the Cayman Islands or Bermuda, being listed on an offshore stock exchange, most commonly Hong Kong. Such entities typically raise debt from offshore creditors through banking facilities, notes or bonds issued by a separate company. The offshore borrower then holds operating assets in China through wholly foreign-owned enterprises (WFOEs) incorporated in China. The parent, or offshore intermediate parent holding company, then moves funds into the Chinese operating subsidiaries mainly through equity injections due to regulations restricting the proportion of funding which may be raised through debt.

A simplified diagram of a typical secured onshore/offshore financing structure is shown below.

DIAGRAM: a typical secured onshore/offshore financing structure



ONSHORE AND OFFSHORE STRUCTURAL ISSUES

This type of financing structure presents a number of issues for the offshore creditors in a stressed scenario:

- the offshore financial creditors' debts are likely to be structurally subordinated to those of the Chinese operating subsidiaries, unless the offshore financial creditors have direct claims against the operating subsidiaries (through guarantees or other security). But this is unlikely as there are restrictions on onshore companies providing guarantees or pledging their assets as security, as further detailed below. This means that cash raised from the onshore operating companies will be used to repay operating subsidiaries' debts before any value reaches the parent/intermediate holding company. The onshore debt is often substantial, particularly for Chinese property companies, which commonly finance construction projects by borrowing from onshore banks and pledging property as security for these loans. For example, several onshore banks were able to file suits to freeze the assets of Chinese real estate developer Kaisa Group (which in 2014 became the first Chinese real estate enterprise to default on US currency debt), while offshore lenders have largely been left in the position of passive onlookers;
- offshore issuers/borrowers are able to pay interest out of dividends from their onshore operating subsidiaries, but they are dependent on a refinancing for the payment of the principal because the repatriation of equity funds from onshore subsidiaries requires a lengthy and complicated approval process. For this reason, they are reliant on the offshore refinancing of the offshore debt. However, if financing conditions tighten, offshore borrowers/issuers may find it increasingly difficult to refinance their maturing debt;
- offshore structures will often have obligors incorporated across a number of jurisdictions. As noted above, these may include the Cayman Islands, Bermuda, BVI and Hong Kong. Any compromise with debt holders will need to be reached in a manner that is not vulnerable to challenge in the courts of other relevant jurisdictions. This issue is exacerbated by the fact that Hong Kong, China, Bermuda, BVI[1] and the Cayman Islands have not adopted the UNCITRAL Model Law on Cross-Border Insolvency (Model Law), which provides a framework of legislation for how the courts of one country should recognise insolvency proceedings commenced in another. There are no other co-operation/recognition protocols between these jurisdictions; and
- companies may be able to increase the amount of onshore debt, thereby rendering the offshore creditors more deeply subordinated. For example, offshore bonds usually have restrictions on subsidiaries raising onshore debt, but the definition of debt may not capture bonds and other capital-market instruments, thereby allowing onshore subsidiaries to increase their debt.

These structural problems are particularly relevant to the global investor community given that China now has a significantly larger share of Asia's US dollar bond issuances. As at the date of writing, Chinese companies account for c.20% of all outstanding US dollar-denominated bonds, having issued US$275bn of bonds since 1 January 2012, up from 8% as at the end of 2011.[2]

RESTRUCTURING THE OFFSHORE DEBT OBLIGATIONS

The options in relation to the offshore debt obligations are recognisable but face particular challenges.

Enforcement of security

If offshore security such as a debenture or share pledged has been created in favour of the offshore creditors, receivers may be appointed over the pledged assets or other enforcement action may be taken under applicable law. However, it is likely that offshore creditors will not have been granted tangible security by the operating companies in China given historical restrictions imposed by the State Administration of Foreign Exchange of China (SAFE) on Chinese companies granting security for offshore loans. For example, before 1 June 2014, approval of SAFE was required for an onshore entity to grant a guarantee to offshore financial creditors.[3] Given these restrictions, at most the onshore operating subsidiaries might have guaranteed the principal indebtedness (on an unsecured basis) and the offshore shareholder may have pledged its equity interest in the operating subsidiaries as security for the loan/bonds.

Exchange offer and tender offer

If the offshore debt constitutes bonds, it may be possible to restructure the debt through an exchange offer or a tender offer. In an exchange offer, the issuer will make an offer to holders of its outstanding bonds to exchange the existing bonds for newly issued debt securities or a package of debt and equity securities designed to accomplish the company's financial goals. In a tender offer, the issuer will make an offer to its bondholders to relinquish their bonds in exchange for a cash payment, which in a distressed scenario may be less than the face value of the bonds. These offers are framed such that they only become effective if a specified majority of the bondholders accept the offer. Exchange offers and/or tender offers may be combined with a creditor "cram-down" procedure (for example, a scheme of arrangement[4] or US Chapter 11 proceedings) to ensure that the offer is imposed upon dissenting creditors, subject to the consent of the requisite majority of creditors being obtained.

Scheme of arrangement

One of the most common methods of imposing a restructuring deal on dissenting offshore creditors is through one or more schemes of arrangement. A scheme of arrangement is an arrangement or compromise entered into between a company and its creditors or members.

Hong Kong law[5] provides for a scheme of arrangement on substantially similar statutory and procedural terms to a scheme of arrangement under Pt 26 of the English Companies Act 2006. In broad summary, the Hong Kong court will approve a scheme of arrangement that is approved by a majority in number of the class of creditor representing at least 75% of the claims of those present and voting in support of the scheme at a meeting

convened by the court, provided that the Hong Kong court is satisfied that the scheme is fair in all the circumstances. Dissenting creditors have the ability to object in court but, if the scheme is ultimately approved, each scheme creditor will be bound by its terms.

A Hong Kong law scheme of arrangement is a powerful tool for restructuring offshore debt given that the Hong Kong court has demonstrated willingness to sanction a scheme of a foreign company.[6] In the recent case of *Re LDK Solar Co Ltd*, the Hong Kong court concluded that it was not necessary to satisfy the three "core requirements"[7] associated with the winding up of an unregistered company when determining whether to sanction a scheme of a foreign company. Instead, the court's ability to sanction a scheme of a foreign company should only be exercised when a "sufficient connection" with Hong Kong can be established. Determining whether a sufficient connection exists is a matter of judgement in view of the evidence. In *LDK*, G Lam J was satisfied that a sufficient connection could be established given that, amongst other things:

- certain of the claims of the scheme creditors were governed by Hong Kong law;[8]
- certain of the scheme creditors were domiciled in Hong Kong; and
- the Hong Kong law schemes represented part of a multi-jurisdiction restructuring exercise being promoted in parallel with schemes of the relevant LDK entities in their place of incorporation.

Given that offshore debt is commonly governed by Hong Kong law and certain lenders/bondholders may be domiciled in Hong Kong, it is relatively common for "sufficient connection" with Hong Kong to exist such that the Hong Kong court will accept jurisdiction for the purposes of sanctioning a Hong Kong law scheme of arrangement to facilitate the restructuring of offshore debt.

If the borrower of the offshore debt subject to a Hong Kong law scheme is not a company incorporated in Hong Kong, it will likely be necessary either to seek recognition of the Hong Kong court's scheme sanction order in the jurisdiction of incorporation or to implement a parallel local law scheme of arrangement (on substantially the same terms as the Hong Kong scheme of arrangement). Given that neither Hong Kong, the Cayman Islands nor BVI have adopted the Model Law, parallel local law schemes are commonly implemented to avoid any issues that may arise in the seeking of a Hong Kong court order.[9]

Provisional liquidation

A Hong Kong law scheme of arrangement does not give the borrower/issuer or other obligors in the group automatic protection against creditor actions. Further, the act of proposing a scheme may constitute an event of default under the group's finance agreements. If necessary, the relevant companies may seek protection through the appointment of provisional liquidators upon the presentation of a winding-up petition.[10] The appointment of provisional liquidators under Hong Kong law and certain other typical offshore jurisdictions (eg, the Cayman Islands) gives rise to a stay of creditor claims while the scheme process continues. If a restructuring is successfully implemented, instead of proceeding with the liquidation process, the provisional liquidator seeks a stay of the winding-up proceedings.

Given the absence of a statutory framework under Hong Kong law to implement a formal corporate rescue, the Hong Kong courts have demonstrated that they are receptive to the creative use of provisional liquidation to facilitate a financial restructuring.[11]

Further, whilst Hong Kong's corporate insolvency laws do not expressly provide for the recognition of an overseas insolvency,[12] or those administering it, case law[13] has suggested that the Hong Kong court will generally recognise the status of an insolvency representative appointed by an overseas court and provide assistance. Therefore, if it is not possible to commence provisional liquidation of a foreign entity in Hong Kong (because, for example, it is not possible to satisfy the three "core requirements" referred to above) then it may be possible to commence provisional liquidation in the jurisdiction of incorporation of the borrower/issuer entity and for the Hong Kong court to recognise and enforce any associated moratorium.

Chapter 11

A filing in the US Bankruptcy Court under Chapter 11 of the Bankruptcy Code may act as an additional or alternative restructuring tool. A Chapter 11 filing gives rise to a worldwide automatic stay. Financial and other creditors that have dealings in the US should be reluctant to risk being held in contempt of the federal bankruptcy courts and therefore may refrain from seeking to enforce their claims.

If the offshore financing structure includes New York law governed bonds (or other New York law governed debt obligations) that are restructured pursuant to a Hong Kong scheme of arrangement, it will likely be necessary to have the Hong Kong court scheme sanction order recognised in the US by commencing an ancillary bankruptcy process under Chapter 15 of the US Bankruptcy Code, unless a Chapter 11 order is made.

RESTRUCTURING THE ONSHORE DEBT OBLIGATIONS

Dealing with the onshore debt obligations and offshore creditor involvement in the onshore restructuring options presents new challenges to a financial restructuring.

Bankruptcy law in China

On 1 June 2007, the Enterprise Bankruptcy Law (EBL) came into force in China. The progressive legislation created a unified bankruptcy regime that draws heavily on US Chapter 11 technology in an attempt to facilitate corporate rescue. The law introduced an "administrator" into the bankruptcy process to take control of the debtor's assets and to exercise a broad range of administrative responsibilities. The EBL also contains a limited creditor cram-down mechanism under which a majority in number and two thirds in value for each affected class present at the creditors' meeting is required to approve a restructuring plan. All classes must approve a plan for it to be effective, but cram-down applies subject to specified factors similar to those under

Chapter 11.

However, notwithstanding the modernisation of the insolvency and restructuring regime in China, there have been a relatively small number of bankruptcy and insolvency filings in the last few years,[14] although reported cases are difficult to identify for offshore creditors and observers. Commentators have concluded that the limited use of the EBL may be a result of significant government intervention in the Chinese market. It is not uncommon for government branches, particularly at the local level, to exercise influence in bankruptcy and reorganisation cases on the grounds of maintaining social stability and the protection of state assets. Such practice has distorted market discipline and potentially resulted in the inconsistent application of the insolvency and restructuring statutory regime by the Chinese judiciary. There is also uncertainty as to the ability and/or willingness of the Chinese judiciary to exercise their wide ranging powers under the EBL in the face of potential government intervention. There are some signs that the central government's crackdown on corruption is reducing the propensity for local authorities to provide support to onshore companies when offshore creditors seek to enforce their rights through the offshore/onshore structure.

THE ROLE OF OFFSHORE CREDITORS IN RESTRUCTURING ONSHORE DEBT OBLIGATIONS

The factors detailed above mean that the onshore bankruptcy and/or restructuring process can still be challenging for offshore creditors.

Foreign creditors have sought to exert influence in the onshore debt restructuring process through effecting offshore appointments (eg, liquidation, provisional liquidation or receivership) and then exercising shareholders' rights over the operating subsidiaries to implement a restructuring or realisation strategy, subject to recognition by the Chinese court.

Chinese courts are prepared to recognise the judgments of foreign courts made in insolvency proceedings only when certain conditions are met. Chinese courts may do this through:

- an international treaty of mutual recognition with that foreign jurisdiction; or
- the doctrine of reciprocity, provided that it would not breach the principles of Chinese law and would not be contrary to the public interest, sovereignty or national security of China. Further, the Chinese court will also consider whether or not such an order would undermine the interests of the creditors situated in China.

To date China has only implemented international mutual recognition of proceedings treaties with Italy[15] and Turkey. The implementation of additional recognition treaties would provide assistance to offshore creditors whose primary recourse is to recommence insolvency proceedings under Hong Kong law or other local law.

It is difficult to assess the extent to which the Chinese courts would be willing to recognise foreign judgments under the doctrine of reciprocity. There is little, if any, guidance from the courts or legal provisions as to how this doctrine will be applied in practice. This lack of precedent leads to greater uncertainty for offshore appointment holders.

If the Chinese courts refuse to recognise formally the appointment of an offshore insolvency officeholder or foreign insolvency proceedings, there will be difficulties in exercising rights on behalf of the shareholders against companies and assets in China. Particular issues include:

- offshore appointment holders often find it challenging to remove onshore companies' existing directors and legal representatives without the consent and co-operation of those individuals. The State Administration of Industry and Commerce (SAIC) provides that the documents required to effect the removal must be executed by the director(s) and/or legal representative(s) being removed. Further, the key management figures of the onshore company may still have influence over local authorities and may attempt to prevent registration of the change. The local SAIC may also not accept the submission of documents from offshore appointment holders' representatives. In an encouraging sign, on 11 June 2014, the Supreme People's Court overturned a decision of the Fujian High Court in the case of *Sino-Environment Technology Group Limited*, ruling that a sole shareholder resolution to remove the legal representative of a Chinese company is valid and enforceable, notwithstanding that the records of the local State Administration of Industry and Commerce had not been updated. This case suggests that the Chinese courts are becoming more amenable and recognising the legitimate interests of offshore creditors and insolvency appointment holders;
- offshore appointment holders are likely to find it difficult to obtain physical possession of title, premises, certificates, chops (a stamp-like device used to imprint a Chinese company's official mark to validate contracts and other official documents) and other onshore assets such as books and records. This issue is exacerbated by the difficulties detailed above regarding the ability of offshore officeholders to effect a change in the onshore companies' senior management structure; and
- local governments have been known to take control of assets in China in an attempt to preserve stability and local jobs.[16] This leaves the offshore appointment holder in an uncertain position.

WHAT NEEDS TO HAPPEN

The restructuring methods outlined in this article provide offshore creditors with a useful array of tools to restructure offshore debt obligations. There is a growing body of evidence to suggest that these restructuring tools are able to chip away at the Chinese wall in order to extract value onshore. There are ways in which offshore creditors may exert political and commercial pressures onshore to improve the prospects of a successful recovery of their claims. Further, as China continues to modernise its legal system in its drive to become an open market economy, it is anticipated that the onshore restructuring

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process will become less opaque, less susceptible to local government interference and more aligned to the interests of foreign creditors.

Elsewhere, financial creditors have come to accept the political and social priorities of jurisdictions and have implemented successful financial restructurings having regard to such priorities. To do this requires both an understanding that (if at all possible) the preservation of the commercial enterprise is the first priority and that legal and jurisdictional assistance is required to apply basic principles to effect a restructuring. The development of such an understanding in China is required as a next step to allow foreign creditors to participate in the restructuring of onshore businesses. ■

1 Note: BVI has signed up to the Model Law, but it has not yet put the enabling statute into effect.

2 'US Dollar Debt of Emerging Market Firms' by Reserve Bank of Australia dated December 2015.

3 It should be noted that these restrictions have recently been somewhat relaxed by the Regulations on Foreign Exchange Administration of Cross-Border Guarantees and Security and the Operational Guidelines on Foreign Exchange Administration of Cross-Border Guarantees and Security. For further information, please see Linklaters' publication *Relaxation of PRC regulatory restrictions on cross-border security and guarantees* dated May 2014.

4 For example, the restructuring of DTEK involved a parallel-track exchange offer, consent solicitation and English law scheme of arrangement.

5 Section 673 of the Hong Kong Companies Ordinance (Cap. 622).

6 The power of the Hong Kong court to sanction a scheme of arrangement extends to a "company" as defined in s 688 of the New Companies Ordinance, namely any company which is "liable to be wound up under the Companies (Winding Up and Miscellaneous Provisions) (Cap. 32). This test covers both companies incorporated under Hong Kong law and foreign companies which are not registered in Hong Kong but which may still be wound up as "unregistered companies".

7 These core requirements are: (i) there must be a "sufficient connection" with Hong Kong; (ii) there must be a reasonable possibility, if a winding-up order is made, of benefit to those applying for the winding-up order; and (iii) one or more persons interested in the distribution of assets of the company must be persons over whom the court can exercise jurisdiction, as established in *Re Real Estate Development Co* [1991] BCLC 210, 217 and *Re Yung Kee Holdings Ltd* [2014] 2 HKLRD 313 (CA).

8 As a matter of Hong Kong law, a foreign composition does not discharge a debt unless it is discharged under the law governing the debt: *Hong Kong Institute of Education v Aoki Corporation* [2004] 2 HKLRD 760; *Anthony Gibbs & Sons v Société Industrielle et Commerciale des Métaux* (1890) LR QBD 399.

9 In *Re LDK Solar Co Ltd*, the Cayman-incorporated borrowers implemented Cayman law schemes of arrangement on substantially the same terms as the Hong Kong law schemes of arrangement.

10 Note that provisional liquidation does not entail the liquidation of a company and the name is therefore something of a misnomer. Provisional liquidation is an interim process under the control of court-appointed officers pending the hearing of the winding-up petition.

11 For example, in *Re Keview Technology (BVI) Ltd* [2002], the court extended the power of the provisional liquidators to allow them to restructure the company. However, note that, in *Re Legend International Resorts Ltd* [2006] 2 HKLRD 192, the Hong Kong Court of Appeal stated that the practice of appointing provisional liquidators to rescue companies went beyond the Hong Kong Companies Ordinance as the purpose of a provisional liquidator is to wind up the company. This case brings into doubt the willingness of the Hong Kong court to grant extension of powers to provisional liquidators to allow them to rescue a company.

12 For example, under English law, s 426 of the Insolvency Act 1986 allows for judicial comity between the English courts and those of relevant countries or territories as designated under English law.

13 For example, see *Joint Official Liquidators of A Co v B* [2014] 4 HKLRD 374.

14 In 2014, there were just 2,630 recorded corporate insolvencies in China ('Corporate insolvency in mainland, Hong Kong seen rising this year' by *South China Morning Post*. dated 31 May 2015) compared to (for example) 17,117 corporate insolvency/reorganisation proceedings in the UK (The Insolvency Service Statistics).

15 In 2000, the courts in China recognised an order for bankruptcy from the Milan court with respect to *B&T Ceramic Group s.r.l.*

16 For example, in the case of *Smart Union Group (Holdings) Limited*, a toy producer listed in Hong Kong, the local government took action through the local courts to sell the company's assets located in Dongguan to pay outstanding wages and to prevent social unrest.

Further Reading:

- Overlapping jurisdiction and the Chinese courts [2016] 3 JIBFL 174A.
- Overseas beneficiaries' remedies for breach of trust in China [2015] 6 JIBFL 364.