The challenges ahead for China's "patchy" restructuring laws

Friday 27 November, Toby Luckhurst

With China's economic outlook looking uncertain, speakers at a recent event discussed whether the country's "patchy" restructuring laws are equipped to handle any potential fallout, particularly as far as foreign investors are concerned. Toby Luckhurst reports from Singapore

Lawyers and advisers from DLA Piper, offshore firm Harneys, KPMG, AlixPartners and FTI Consulting spoke in Singapore last week about the challenges of restructuring in China – on target for its slowest economic expansion in 25 years.

DLA Piper restructuring partner **Jonathan Leitch** from the firm's Hong Kong office acted as moderator in the panel discussion, at the Turnaround Management Association's Asia-Pacific conference in Singapore on 19 November.

Despite the consensus that China's restructuring regime has "light spots and dark spots", one speaker shared his positive experience of the reorganisation of solar panel manufacturer Shanghai Chaori Solar – the first Chinese company ever to incur a domestic bond default in March last year – and said there was still hope for ways to achieve an efficient process.

"While the process doesn't bear resemblance to Chapter 11 or schemes of arrangement, the outcome is the same," he mused.

Leitch opened the panel by discussing China's weakening economic growth. "There is evidence the government is using various weapons in its armoury to stimulate growth," he said, such as interest rate cuts, currency devaluation and abandoning the one-child policy.

But AlixPartners director **Brent Carlson** from Hong Kong said these measures may not be enough to offset China's economic woes. "China is a victim of its own success, its own industrial policy," he said.

The country took on a massive amount of debt to fund its development, especially following the global financial crisis in 2008. Its export-led development model exacerbated the problem. The government pumped credit into the economy simply to keep it afloat, to such an extent that the debt is now equivalent to 300 per cent of the country's GDP.

"China is digging a bigger and bigger hole", said Carlson. "This is a Star Trek moment – China is going where no one has gone before, and it just keeps on going."

Carlson eschewed the "overly optimistic" belief in the market that the country will see growth between 5 and 7 per cent over the next several years. He argued that economic growth is driven by three core factors – increasing capital, labour and productivity – and China does not have any of these factors.

In terms of demographics, China's total population will peak in the next decade, and its working age population is dropping as a result of the one-child policy – hence its recent reversal.

Productivity similarly looks grim; just over half of China's population lives in urban environments, but even this is misleading as China defines an urban space as anywhere with more than 1,500 people per square kilometre – a definition that would include many rural areas in the US.

Partner **Edward Middleton** from KPMG's Hong Kong office agreed with Carlson, flagging up the looming issue of non-performing loans (NPLs). China's big state banks are selling NPLs, but not to private investors or the international market – instead keeping the debt domestic. Asset management companies in China are running out

of capacity to deal with these loans. "It's a rather unattractive picture," said Middleton.

He explained one of the key problems with the NPLs is the "fairly ridiculous policy" under Chinese law that when a bank downgrades an NPL, it has to take on 150 per cent of the loan – essentially paying half the loan on top of handling the debt. "Banks would rather sell loans at 80 per cent than lose 150 per cent – they're better off selling," he argued.

As a result of these NPL problems, Middleton said he anticipates a growing number of insolvencies in China, especially considering the banks refuse to take haircuts on debt belonging to foreign companies operating there. The government has asked domestic banks to reduce their exposure to debt, so when foreign debtors ask for a haircut they get nowhere.

"The banks are fully secured, so why take a haircut?" he said. "This policy directive is hampering the freedom of manoeuvre. That's why it's so fascinating to be getting to grips with these issues – the policies and procedures have to change because China cannot carry on doing things in the old way."

However, it was Middleton who cited some hope in the successful restructuring of Shanghai Chaori Solar, on which KPMG advised.

He explained that over 6,000 "mom and pop" businesses, small family-owned or independent ventures, stood to lose their investments when the company defaulted. To the surprise of the market the Chinese government did not bail out the solar panel manufacturer, but instead allowed it to enter administration. It was restructured successfully in just four months.

"It was an intense process fraught with difficulty," said Middleton. "Some of the mom and pop companies turned up to the creditors meeting armed – there was airport type security."

Despite the anger from creditors, Middleton says the restructuring worked. "The process passes muster. It was dealt with quickly, proper solutions were found, and the mom and pops got everything back because investors recognised they were a ransomed group of people."

Middleton credits the judge for the success of the restructuring. "The way a restructuring is conducted in China is almost informal. You talk to the judge over the phone, and judges will meet people over coffee. But it's inclusive. The judge says, 'You're the professionals, tell me how to assist the process.'"

The judge's proactive and cooperative outlook was the reason KPMG were recruited to handle the restructuring, he added. "The court in Shanghai was [aware of] Chaori Solar's operations outside China. It has big operations in half a dozen European countries, and this is the reason a firm like ours was given the role."

Ian Mann, partner at Harneys in Hong Kong, argued that the major problem for restructuring in China is structural subordination – the rule that foreign investors in companies that have operational assets in China have no real recourse or security and are systematically subordinated to local creditors. As a result, many companies list their companies in Hong Kong or another offshore hotspot like the Cayman Islands or British Virgin Islands.

Moreover, China is not a signatory of the UNCITRAL Model Law, so companies must throw out such concepts as main and non-main proceedings and the centre of main interest, and instead rely on common law. Mann referred to the 1890 case of *Antony Gibbs Sons v La Société Industrielle et Commerciale des Métaux*, in which an English court ruled that foreign courts cannot extinguish foreign debts.

"Put aside COMI," said Mann. "It is the local law of the company where it is incorporated that will govern the company."

"The reason China hasn't signed up to UNCITRAL is that it cannot bear the thought of ceding its sovereignty," he added. "It is very conscious of its sovereignty, and the thought of turning over assets to foreign courts is anathema to China as a nation."

However, Mann said he believed systematic subordination is eroding as a result of the Chinese government's desire to maintain economic and political harmony. In the case of LDK Solar, another Chinese solar panel manufacturer that missed a bond payment in August 2014 and had US$2.8 billion in debt by the third quarter of that year, the Chinese government realised the need to work with offshore investors and provide new money onshore because it feared the loss of thousands of jobs in one province.

Despite these successes, the system remains very difficult to manoeuvre, according to FTI Consulting's Marcus Paciocco based in Shanghai. He explained that local lenders tend to be very traditional in how they approach problem loans.

There is a lack of moratorium in cases where banks get together to discuss a problem borrower. “They’ll agree in a meeting to continue to roll over facilities, only to have one of them go off and pull the trigger and call in their loan,” says Paciocco. “There is no level of trust there. It’s very difficult to forge out of court restructuring deals, especially within the small and medium-sized enterprise bandwidth.”

Other panels at the two-day conference in Singapore discussed ways of unifying Asia-Pacific restructuring regimes, the successful restructuring of Australian miner Atlas Iron and the restructuring of Indonesian shipping company PT Berlian Laju Tanker TBK. The event took place at the Westin Hotel in Asia Square, with a drinks reception on Thursday night at restaurant bar Cook & Brew on the 33rd floor.