

# CREDITOR PARTICIPATION IN CHINA AND HONG KONG, CHINA

by  
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The theme of creditor participation can be looked at from two angles: the legal framework and the commercial realities. Focusing on China and Hong Kong, China, there are two questions to answer: 1) do creditors participate?; and 2) do creditors want to participate? The answer to both of these questions is: probably not.

## 1) The legal framework

Let us set the scene first by referring to the following table, which describes formal insolvency proceedings in Hong Kong, China and China:

**Table 1. Participation in formal insolvency proceedings**

Mode/Participation	HK–CVL	HK–Court	China– Now	China–2 <sup>nd</sup> Draft
Appointment	Yes	Yes	No	Yes
Meetings	Yes	Yes	Yes	Yes
Committee of Inspection	Yes	Yes	No*	Yes
Reports	No	No	No	No
Complaints	Yes	Yes	Yes	Yes
Closing	Yes	Yes	No	No

Note: HK–CVL: Creditors’ Voluntary Liquidation in Hong Kong, China; HK–Court: Compulsory Liquidation in Hong Kong, China; China–Now: Bankruptcy (Liquidation) under the 1986 Enterprise Bankruptcy Law; China–2<sup>nd</sup> Draft: Draft (Revised) Bankruptcy Law as at October 2004.

\*Chairmen’s Committee formed in GITIC bankruptcy, subsequently introduced in 2002 Supreme Court Rules on the interpretation of the 1986 Enterprise Bankruptcy Law.

Without going into an excessive discussion of procedural details, “Appointment” in the table above refers to the ability of creditors having any input or influence on the choice of the incumbent/replacement insolvency administrator. It should be noted that under “China–Now”, the court has absolute power to appoint members to the bankruptcy/liquidation committee, which administers the bankruptcy proceedings; whereas under “China–2<sup>nd</sup> Draft”, although the court makes the formal appointment of the administrator (which will replace the bankruptcy/liquidation committee), creditors at a meeting of creditors may object to the appointment and ask the court to appoint someone else.

With regard to creditors' meetings, there are large differences in their nature, powers and frequency, though creditors generally do have the right to attend and, where necessary, request the convening of such meetings. However, most creditors' meetings are not held on a scheduled or regular basis.

Again, where there are committees of inspection/creditors' committees, their powers and mode of operation are also quite different. Ironically, it is not uncommon for creditors to take the (incorrect) view that one of the incentives for joining these committees is to protect and pursue the creditor's own interest. Hence, related parties often compete and argue over appointments to the committee. The courts in Hong Kong, China have rejected the appointment of proposed members, resulting in no committee being formed.

Unfortunately, there are no formal requirements for formal written reports to be prepared or sent to creditors, although these are often provided during formal creditors' meetings as a matter of good professional practice by the insolvency practitioner. One exception is that of the "HK-Court", where reports of progress in a prescribed format are required to be filed with the court, and creditors may apply to inspect such reports.

In the event of disgruntled creditors, there are avenues for creditors to file their complaints with the relevant regulatory bodies and/or the court. These situations are rare, especially in China, where, effectively, the court would be dealing with complaints filed against the bankruptcy/liquidation committees that discharge their administrative duties under the direction of the court.

When an administration comes to a close, creditors are not necessarily being notified of any final meeting or the fact that the liquidation is about to close.

In a nutshell, the legal framework is such that creditors will have to make extra efforts to even have the opportunity to participate, whether in Hong Kong, China or in China. Take a typical Hong Kong, China court liquidation as an illustration: after the first creditors' meetings appoints the liquidators and a committee of inspection, creditors may not hear ever again from the liquidators if there are no dividends. Or they may simply receive a notice of dividend followed by a dividend cheque, if their claims are not subject to dispute. How can creditors participate?

## 2) The commercial reality

So, why are creditors not keen to participate? Much has been said regarding the changing of creditors profiles in insolvency situations these days. The increasingly significant hedge funds, distressed debt traders, and specialist investment vehicles often take a totally different view and approach to handling insolvency situations compared to traditional lenders and creditors.

The following discussion focuses more on Hong Kong, China than China:

- 1) Other than the change in creditor profile, which often comes together with a generally decreasing security cover for most creditors (secondary debt traders in particular), there is now much direct "zero-sum game" type of competition in multi-creditor situations. The chairman of a listed company in Hong Kong, China was heard to say that they purposely use over 20 bankers so that no one banker will have an overall understanding of exactly what they are doing, or not doing, as the case may be.

- 2) There is a jurisdictional mismatch. Whilst it is common that debtors maintain multi-jurisdictional operations these days, creditors are often bound by resources and other factors to taking a relatively simplistic view of matters, and looking at things predominantly from a local jurisdiction perspective.
- 3) There is an asset/liability mismatch. Here the debtors are organised in a way such that creditors have no direct control over the material assets and operations of a conglomerate. Listed companies, which often borrow funds for use in a group, do not have direct ownership of the operations or assets. For example, creditors who are owed more than HKD (Hong Kong dollar) 3 billion (over USD (United States dollars) 400 million) via lending in Hong Kong, China have no direct exposure to and control over a Chinese 5<sup>th</sup> tier subsidiary company of the group that directly controls some 40 joint ventures of the group in China.
- 4) A phenomenon that could be referred to as “ownership musical chairs” has emerged. Here, creditors do not know for sure who the true owners of an operation are, or for how long they will remain owners, as the majority ownership keeps changing hands every so often. A direct consequence is that there is no commitment by the owners to actually improving or even meaningfully running the operations. All they do is conduct financial manoeuvres to raise further funds from shareholders, or try to borrow more. All views are short term.
- 5) Sadly, most corporate failures these days have an element of irregularity if not outright fraud. What would one do if the chairman of a major listed company ran a parallel private office of not less than 10 people to work on a full-time basis producing falsified documents, or genuine documents for fake transactions, and in good anticipation of the queries and demands of the auditors during regular audits? In this regard, the common use of “local L/Cs” in Hong Kong, China for the sale and purchase of massive quantities of aluminium foil, or ingots, or other non-perishable goods from one end of Lockhart Road<sup>1</sup> to the other is not a welcoming sign. But, all parties to these transactions turn a blind eye towards them, at least until things go wrong.

Many creditors are fully aware of these risks when the lending is done, or the credit given (or soon thereafter). If and when things turn sour and insolvency problems arise, they tend to take a practical and bold view and almost immediately make a substantial if not full provisions, cut their losses, and hope that something might come back. However, they know the chances of any meaningful recovery are slim.

### 3) Creditor mentality

After a provision is made, the concern becomes the subsequent internal reporting and any need for further provisioning insofar as the creditor is concerned. The focus is no longer on any prospective absolute return, let alone the chances of any return. Hence, a rather negative mentality arises. The following are symptoms of this mentality:

- *No good money after bad*: creditors are most reluctant to spend, and will avoid spending an additional dollar to recover the bad debt;
- *Take the money and run*: where recoveries are imminent, or where there are already assets realised in an administration, creditors tend to prefer making an early distribution

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1. Lockhart Road is a road of less than a mile long in the district of Wan Chai in Hong Kong.

from what is available, over investing the current realisations in further investigation and recovery actions;

- *Low/no risk acceptance level*: unlike when in lending mode, creditors now tend to be extremely risk adverse. They prefer actions only where there is absolute certainty of a positive outcome; and
- *Creditor funding is a near impossibility*: seeking and obtaining funding from traditional lenders and creditors is now almost an impossibility, unless major international issues and considerations (e.g. in a multi-creditor multi-jurisdiction situation) are involved.

Without funding, there is only so much (or so little) that any liquidator can do in terms of investigation and retrieval of assets to feed and support any further investigations and recovery proceedings.

#### 4) Sure-win package for fraudsters

Unfortunately, in the course of the last 10 years or so, commercial fraudsters have learned through collective experience that they will do well by adopting the following simple steps:

- 1) Transfer out all assets;
- 2) Sack all employees but pay them well;
- 3) Burn all books and dump the computers; and
- 4) Resign as directors and leave the country (or just go into hiding).

Fraudsters know the tricks and the fact that most creditors will not and cannot pursue them. This process is self-feeding and a vicious circle is formed. More creditors are tricked and more losses are reported. One used to talk of losses in terms of millions, which have now become billions.

#### 5) The way forward

Many parties have their ways of contributing to resolving the current awkward position of general creditor apathy. It is of paramount importance that the following factors be taken into account when one tries to consider one's own position and contribution:

- 1) *Break the vicious circle*: the self-feeding fraud circle must be broken. If not, the more let-offs there are, the more rampant the fraud is going to be;
- 2) *Macro considerations*: one should not consider only one's own position (although admittedly this is not easy in a pragmatic commercial environment). Unchecked commercial fraud will lead to higher costs of lending/providing credit, or a reluctance to provide credit generally, resulting in a sub-optimal use of economic resources in the capital market;
- 3) *Dollar return or take the moral high ground*: when situations of grave public interest are concerned, one should take the obvious moral high ground and consider any dollar return secondary. This is easier said than done and will require stamina and determination, as well as policy decisions at the highest level; and

- 4) *Establish a “Fight Fraud Fund”*: a somewhat far-fetched proposition is for creditors and stakeholders to chip in to set up a general fund of some sort, on some local basis to combat/investigate/pursue fraudulent activities for the common good of the commercial fraternity. But, the practical approach is for creditors to be prepared to provide proper funding and support for investigation and litigation, and take a long-term view on case-specific matters. An alternative is to lend general support to the setup of litigation funding vehicles, and relax the legal niceties of champerty and maintenance.

Where situations of fraud are concerned, and where there are clear indications that the liquidators can at least take matters forward at a reasonable cost, creditors should provide support to liquidators.

## **6) Conclusion**

Creditors generally do not wish to participate. The legal framework is not encouraging them to do so, and the practical commercial considerations dictate that they do not. But, creditors do have to take a macro and long-term view on the current unhealthy practices.

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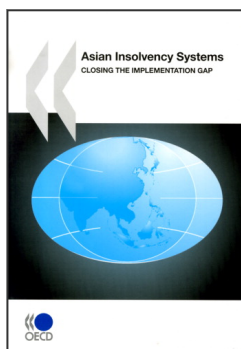
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