

Client Alert

Financial Markets Developments

PRC Pre-IPO Financings: What are the Exit Options?

1. Introduction

In the past few years many investors have provided pre-IPO loans to PRC businesses (mainly in the PRC real estate sector) through the offshore holding companies of those PRC businesses. This was driven by a number of market factors, such as (a) the low financing costs of borrowing US dollars offshore in comparison to borrowing onshore (and the appreciation of the RMB); (b) the attractive returns to the lenders in the event of a successful IPO (which were often equity-like); (c) the ample liquidity in the PRC debt and equity markets reducing the risk of an IPO failing to list by a specified date and (d) demand by companies in the PRC¹ seeking funds to finance plans for rapid expansion in the booming economy and hot property market. The pre-IPO financings were structured to achieve equity-like returns through either the issuance of warrants or rights to acquire the shares at a pre-determined discount in the event that the borrower or an affiliate was listed on a stock exchange (usually on the Hong Kong or Singapore stock exchanges). However, given the current state of the equity markets, exit or loan repayment through IPOs seems unlikely in the near term and, at the same time, refinancing of these pre-IPO loans through the credit markets would also be a challenge given the ongoing credit crunch and a depressed property sector. As a result of these current market conditions, many of these pre-IPO financings are now under extreme stress.² This note explores the options available to offshore lenders when their investments are no longer performing and are in distress.

2. Typical pre-IPO structure

Sponsors

Pre-IPO financing structures were predominantly used in the real estate sector. Many of the sponsors to the Chinese pre-IPO financings were Chinese nationals reinvesting their offshore capital on the Mainland to take advantage of the tax incentives for foreign investments which were available under the former PRC income tax regime. Such tax incentives were eliminated in the new income tax laws which came into effect in 2008 and which mandated a more neutral treatment of foreign direct investments. It is worth noting that in May 2007, the PRC government introduced a circular addressing the issues concerning foreign exchange administration of company financings and round-tripping investments through overseas special purpose vehicles (more commonly referred to as the "round-tripping rules") to avoid wealthy Chinese nationals taking onshore funds offshore and then reinvesting such funds as foreign investment into China to take advantage of the tax breaks. In addition, the sponsors were usually well-connected locally with strong provincial government contacts and had access to land use rights.

¹ For the purposes of this note, any reference to the Mainland, PRC or China shall mean the People's Republic of China, other than the Hong Kong Special Administrative Region, Macau and Taiwan.

² As at the date the "Asia-Pacific Distressed Debt Outlook 2009" December 2008 was published by DebtWire Asia Pacific, real estate developers accounted for nine out of the thirteen Chinese companies identified by Debtwire Asia as stressed.



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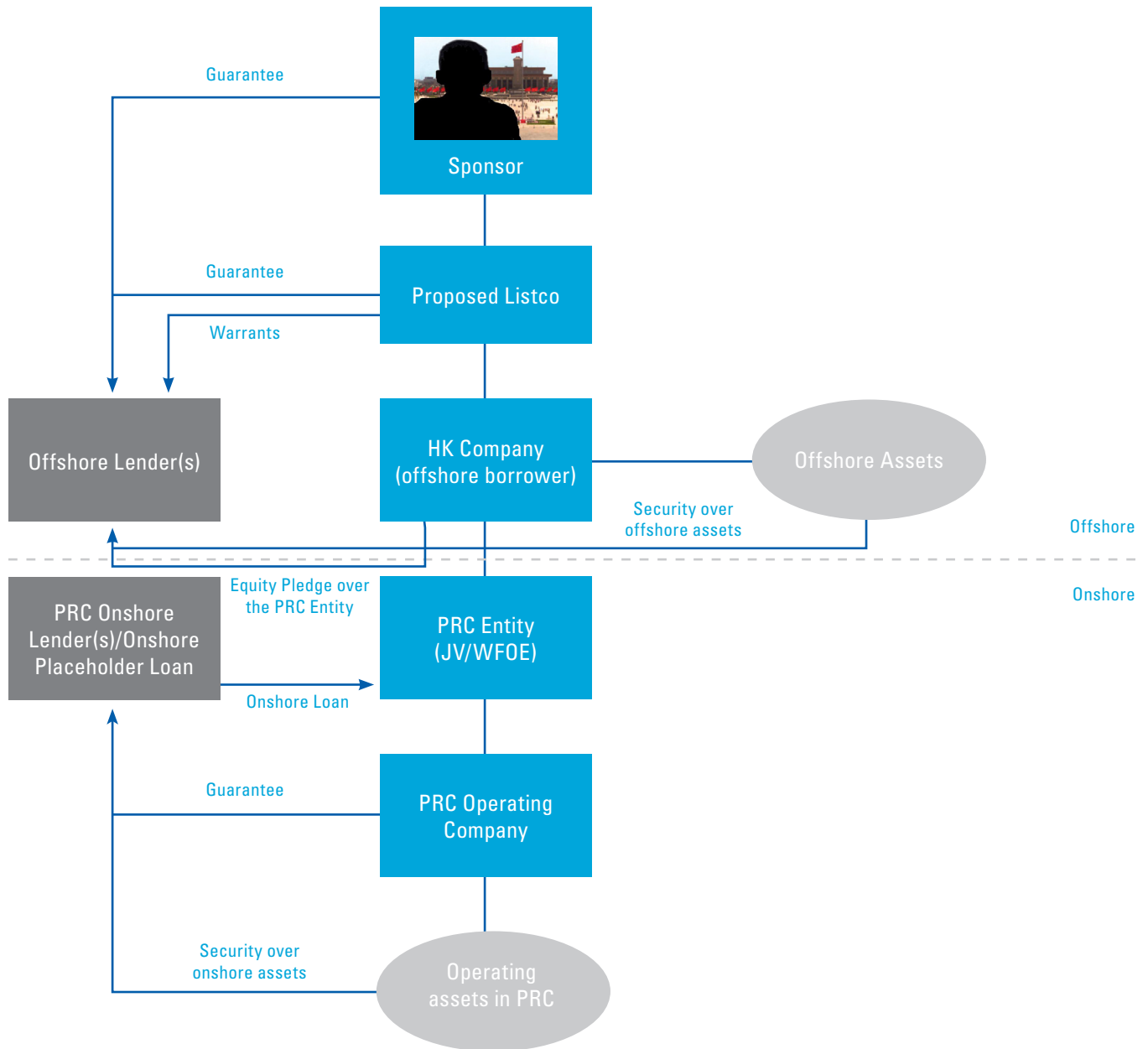
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3. Typical pre-IPO structure

Figure 1



The above diagram illustrates the typical pre-IPO financing structure used by foreign sponsors investing in China.

Offshore and Onshore Entities

The key point to note from Figure 1 above is that Chinese law prescribes that if foreign investors wish to hold onshore immovable assets in the PRC, such assets have to be held through a foreign invested enterprise (“FIE”) (for example, a Joint Venture (“JV”) or Wholly Foreign Owned Enterprise (“WFOE”). This creates the onshore and offshore divide seen in almost all PRC-related investment structures. Whilst the parent holding company/head office function is usually situated offshore, the actual operating and immovable assets (for example, factories, manufacturing plant and machinery, and real estate developments) are held by an onshore entity.

The offshore financing will usually be provided to the intermediate holding company which immediately holds the onshore entity (whether it be a WFOE or JV), the proceeds of which are used as an equity injection onshore and/or shareholder loan to the PRC entity. The offshore lenders are in effect providing a “holdco financing.”

The intermediate holding company which acts as the borrower is usually a Hong Kong or Singapore company because of the beneficial tax treaties³ which have been reached between these jurisdictions.

4. Offshore security and negative covenants

The following are the main forms of protection available to offshore lenders in a typical pre-IPO financing in China:

- Parent and sponsor guarantee.
- Security over the equity interests in the onshore entity.
- Security over any offshore assets of the group.
- Negative covenants contained in the offshore credit agreement to limit the amount of onshore debt and onshore security.
- Letter(s) of undertaking executed by the onshore companies

replicating the positive and negative covenants contained in the offshore credit agreement.

- Covenants relating to increased control over conduct of the relevant pre-IPO company (for example, board representation), increased financial reporting to the offshore lender and/or budgeting requirements. Recently, there has also been a growing trend requiring pre-IPO companies to source further investments and funds into the company.
- Onshore security: Due to China’s stringent foreign exchange control measures, the ability of onshore entities in the debtor group to grant additional security upstream to secure the offshore debt is very limited. However, in some instances, where an offshore lender has onshore operations (that is, a PRC-incorporated subsidiary of the offshore bank which can lend RMB onshore), such onshore lender will provide a nominal loan in RMB to enable onshore security to be created over the onshore assets and for a guarantee to be provided from the offshore companies in the debtor group to secure and guarantee the onshore loan. Although, the onshore security will only secure the onshore loan for the benefit of the onshore lender, the purpose of the onshore security is to act as a placeholder to avoid other onshore lenders obtaining those assets as security. Typically the value of the assets secured is many times over the actual value of the nominal onshore placeholder loan (“onshore placeholder loan”).

5. The state of play with PRC pre-IPO financings

Many of the Mainland real estate developers which have used pre-IPO financings are now struggling. This is partly a result of the measures introduced by the PRC government to limit the rapid appreciation of property prices in 2008. The PRC government imposed, amongst other measures, restrictions on banks making construction loans to property developers and taxes on capital gains from secondary property sales. Whilst some of these measures have been lifted in an attempt to limit the effects of the credit crisis on the Mainland, the austerity measures which

³ Arrangement for the Avoidance of Double Taxation on Income and Prevention of Fiscal Evasion, which provides preferred tax treatment to both businesses and individuals resident in Hong Kong, making Hong Kong an attractive location for setting up an intermediate holding, financing or licensing vehicles for investing in the Mainland. There is a double taxation agreement between the PRC and Singapore titled Agreement between the Government of the Republic of Singapore and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion With Respect to Taxes on Income.

the PRC government imposed, together with the credit crisis, have led to a downturn of the real estate property sector and a rapid deterioration of the businesses of the real estate developers. As a result, many of the pre-IPO companies are now struggling to meet their financial covenants and service their debt.

Stepped-up interest rate, a feature common in the pre-IPO financings, may make it even more difficult for the real estate developers to service their debt. Pre-IPO financings were usually structured on the basis that the pre-IPO company shall list by a certain date, failure of which would result in an increase in the interest rates on the loan to a level which would give the offshore lender an equity-like return. Although this stepped-up interest rate provision was designed to limit the downside risk to the offshore lenders/investors if the IPO does not proceed, the reality is that many pre-IPO companies simply are not able to meet the higher interest payments and this provision may make borrower default more likely. Another concern offshore lenders/investors have stems from the fact that they are finding it difficult to monitor the onshore spending. Accordingly, some offshore lenders/investors have now elected to seek repayment or redemption on their offshore investment.

Restructuring pre-IPO financings is difficult because invariably the cash generating assets will be in the Mainland and the offshore borrower is often only relying on dividends from the onshore companies to service the debt and an IPO exit to repay the principal to the offshore lenders. Typically, only limited amounts can be repatriated offshore in the form of dividend distribution. The problem is exacerbated if the onshore project is a property development in its construction phase or requires further working capital before the project generates any onshore revenue to allow any dividend distribution. In this situation, the offshore lenders/investors may have to evaluate whether allowing further onshore funding from local banks is a viable short-term solution to the cash flow problem. The obvious downside to this solution is that loans

from the local banks would have structural priority to the offshore lenders' investment. On the other hand, if the offshore lenders/investors do nothing, they are left with the prospect of holding a nonperforming investment once their capital has been utilized onshore.

Repatriation of onshore cash to service or repay the offshore debt can be a big challenge. One reason repatriation is a difficult process is due to the fact that funds are normally injected into the Mainland as either a capital contribution or shareholders' loan (subject to certain restrictions applicable to FIEs in the real estate sector).⁴ There are only limited ways to extract funds out of the Mainland, namely by payment of dividends or repayment on shareholders' loans (as the case may be). Whilst repatriation by way of dividends or repayment on shareholders' loans can be done with relative ease under normal circumstances, the amount which can be repatriated is often limited (and not sufficient to repay the offshore lenders' investment) by the operations and capital structure of the company pursuant to PRC laws and regulations. Accordingly, it is very difficult to repatriate a larger amount which is sufficient for an offshore lender/investor to recover its principal. Although capital reductions are theoretically possible (and there is evidence to suggest that this has been done previously), capital reductions require MOFCOM approval and are difficult to justify.

Many of the offshore lenders/investors have also bought into these structures with limited or little due diligence (in particular, over the nature of the land use rights). Under PRC law, only granted land use rights may be used as collateral for financing. The use of allocated land use rights as collateral is subject to the approval of governmental authorities which will usually also require satisfaction of other conditions. Accordingly, the nature of the land use rights can affect the level of protection available to the investors. In addition, the offshore lenders/investors may not have fully understood the fact that the investment remains offshore and enters into the Mainland by way of an equity injection rather than

⁴ In the case of shareholders' loans, the State Administration of Foreign Exchange ("SAFE") issued a circular in July 2007 prohibiting the borrowing of foreign debt by: (a) FIEs established in the real estate sector on or after June 1, 2007; or (b) FIEs established in the real estate sector before June 1, 2007 but have increased their registered capital after June 1, 2007. Further, this circular also prescribes additional foreign exchange restrictions to (a) FIEs in the real estate sector which has obtained its certificate of approval on or after June 1, 2007 from such FIE's local MOFCOM, but fails to complete filing procedures with MOFCOM; or (b) FIEs established in the real estate sector before June 1, 2007 but have increased their registered capital after June 1, 2007, but fail to complete the requisite filing procedures with MOFCOM. The practical implications of such restrictions prevent foreign shareholders of a FIE in the real estate sector from injecting capital for the reason that such FIE is not permitted to have a foreign currency account.

a loan; as a result, the offshore investors would have very little rights over the onshore cash generating assets.

Restructurings are made even more difficult when pre-IPO financings were often sold and distributed to investors in the form of participations or credit default swaps (“CDS”) style instruments. Consequently, the lenders-on-record are often not the parties bearing the risk of the credit. In addition, many of the participants or sellers of the CDS were funds which were only required to post a portion of the face value of the CDS as collateral (giving them more leverage and higher returns on the transaction) leading to a varied and more disperse creditor base.

The remainder of this note discusses ways in which the offshore investor may manage its investment in pre-IPO financings if the borrower is in, or about to, default. In particular, we will highlight some of the options for enforcement and some issues for consideration.

6. Enforcement options

We set out in Appendix 1 a number of options which may be available to offshore investors when faced with a borrower of a pre-IPO financing in distress. The applicability and viability of these options will be dependent on various factors, including the business model and asset values of the debtor, the influence of the sponsor in the province where the onshore subsidiaries operate, the amount of onshore debt and the familiarity of the onshore lenders with pre-IPO financings. However, we note that enforcement in the PRC and some elements of the options below are novel and untested. Moreover, even if the enforcement results in cash being generated onshore, the ability of the offshore lenders to repatriate the funds offshore still remains a challenge.

In summary, there are three options for enforcement which offshore investors may consider:

- (a) **Taking legal action in Hong Kong** to obtain a judgment against the offshore debtor and its onshore subsidiaries in respect of a default under the relevant financing documentation.

The effectiveness of this approach may be dependent on a number of factors, including:

- (i) whether there was a valid contract in place, whether a breach of such contract could be established, and in turn, proof that such breach caused the alleged damages; and
- (ii) to what extent the Hong Kong judgments may be enforced in the PRC.

It is also worth noting that Hong Kong and the Mainland have reached an agreement on the reciprocal enforcement of judgments in civil and commercial matters.⁵ The purpose of such arrangement is to provide a new and convenient mechanism for the reciprocal enforcement of judgments made by the courts of the Mainland and Hong Kong so that a judgment creditor would no longer need to spend a large amount of time and money to bring a legal action again in the place where the property of the debtor is situated. Therefore, in light of this agreement between the Mainland and Hong Kong, assuming the offshore lenders/investors are able to meet certain procedural requirements under the agreement, enforcement of Hong Kong judgments in PRC courts may now be easier. However, even if the Hong Kong judgment is recognized onshore against the onshore company, the ability of the offshore judgment creditor to: (a) have a claim against the onshore company’s estate (in the event of an onshore bankruptcy or reorganization) and (b) repatriate the proceeds offshore, is untested and how this may work in practice still remains to be seen.

Another issue worth noting is that if the onshore subsidiaries have been placed into bankruptcy proceedings in the PRC, the Hong Kong courts may not permit any attachment over the assets of such entity and there may be a moratorium which would prevent the commencement or continuation of any proceedings against the relevant PRC entity (see *CCIC Finance Ltd. v Guangdong International Trust & Investment Corporation* [2001] HKCEA 774).

⁵ Agreement on Reciprocal Enforcement of Judgments in Civil and Commercial matters by the Courts of the Mainland and the Hong Kong SAR pursuant to the Choice of Court Agreements between Parties Concerned.

(b) Offshore Enforcement: Appointment of insolvency representatives by the offshore investors/lenders over the offshore borrower pursuant to the laws governing the insolvency regime of the offshore borrower or the security documents; and/or

(c) Onshore Enforcement: Enforcement of the PRC equity pledges to enable the offshore investors to become a direct holder over the equity interest in the PRC entity.

The primary purpose of options (b) and (c) is to gain control of the offshore borrower's equity interest in the PRC entity and using its influence as the holder of the equity interest to appoint new management (including the legal representative) over the PRC subsidiaries. However, if any of the PRC subsidiaries have been placed in bankruptcy proceedings, under the PRC Bankruptcy Laws, the ability to change the management would be severely restricted and the offshore insolvency representative's remaining option is to enter into dialogue with the onshore administrator to discuss how best to preserve value onshore to enhance the residual value to the offshore investors. If, on the other hand, the offshore lenders are able to replace management,⁶ the offshore lenders may consider (although this is a novel and untested maneuver) instigating a reorganization under Chapter 8 of the PRC Bankruptcy Laws to promote an offshore friendly reorganization plan.

As briefly outlined above, there are several considerations which offshore investors may contemplate in choosing the best option for enforcement. We set out below a description of the FerroChina

case, which highlights some of the issues with which the offshore lenders are currently grappling. In particular, FerroChina provides an illustration of the effects of the appointment of an offshore receiver and institution of reorganization arrangements in the PRC. The future popularity of such an arrangement may depend on the level of confidence offshore investors have in the ability of the new PRC Bankruptcy Law to protect the value of their investments.

7. Recognition of insolvency practitioners

It is worth noting that under Article 5 of the PRC Bankruptcy Law: (i) PRC proceedings are binding on the debtor's property outside of the PRC; and (ii) in certain circumstances, foreign proceedings will be recognized by the PRC courts. There is some indication that, in recent years, Hong Kong liquidators have been increasingly successful in securing cooperation and recognition of their appointment in the PRC. However, there is still some uncertainty on how Article 5 will be interpreted by the PRC courts. Having said that, the recent promulgation of the Reciprocal Enforcement of Judgments Arrangement indicates that there is a policy shift by the Mainland government towards greater cooperation and comity between Hong Kong and PRC judiciaries. In our view, it would be in the interest of both Hong Kong and the PRC to promote closer cooperation between their respective courts in cross-border insolvencies so as to increase certainty and confidence for investors investing in the Mainland through Hong Kong as an offshore financing hub.

⁶ If the offshore lenders appoint new management over the onshore entity, the offshore lenders will need to consider carefully the appropriate individual to appoint as the official representative of the onshore company. This is because the appointment of an individual as a director or legal representative of an onshore company carries with it certain rights, duties and obligations which may expose that individual to personal liability. There is evidence to suggest that directors and officers liability insurance may be available for the onshore directors or legal representative. Please refer to Appendix 1 for further details.

A Quick Look at Chapter 8 Reorganizations

One of the features of the PRC Bankruptcy Law which has been most discussed is the reorganization regime provided by Chapter 8 of the PRC Bankruptcy Law (“Chapter 8 Reorganization”), which was modeled after Chapter 11 to the US Bankruptcy Code. It is believed that the new regime would minimize the need for distressed Chinese companies to resort to liquidation as the only solution to financial distress. Based on our research, it appears that the Chapter 8 Reorganization regime has gained popularity among debtors and creditors and has been adopted in a number of cases.

A Chapter 8 Reorganization may be an option where there is a large number of creditors (and/or where many different types of creditors are involved) and the debtors are operating companies. In contrast, a private work-out may work well where the creditors involved are limited to a few creditors with large exposures, which is often the case of a typical real estate acquisition finance transaction where the borrower entities and the secured assets are effectively ring-fenced.

Advantages

- All creditors may be included in the reorganization plan. If a creditor chooses to opt out, such creditor will not be allowed to subsequently challenge or jeopardize the plan.
- Where the debtors are not cooperative, creditors may still appoint an administrator by applying for a Chapter 8 Reorganization. The administrator will take control of the debtor’s assets and conduct the necessary due diligence on behalf of the creditors.
- Once a Chapter 8 reorganization plan is approved by all classes of creditors and the court, it will bind all creditors, whether or not it was unanimously approved by all creditors.

Disadvantages

- The reorganization plan requires consent from special classes of creditors (for example, tax authority and employees) and these classes of creditors often demand high recovery as a condition to their consent. In contrast, in a private workout, it is possible to temporarily exclude or postpone the inclusion of such special classes of claims from the workout plan.
- Once the court-administered reorganization commences, the process is sometimes outside the control of the general body of creditors because the administrators are given broad powers over the reorganization process which they have to exercise in a relatively independent manner.

Pre-packed plans: Under the PRC Bankruptcy Law, a reorganization plan must be approved by creditors and the court within six months from the date of commencement of the reorganization, or the court would be obliged to initiate the liquidation process upon the expiration of the statutory time frame. An observation is that prior to the formal commencement of some previous reorganizations, it is common for private negotiations to take place between the main creditors and the debtor. Once a plan is agreed in principle amongst the various stakeholders, a creditor would apply to the court to initiate the Chapter 8 Reorganization. The reorganization plan would shortly thereafter be approved by the creditor groups and the court. This is similar to “pre-packed” bankruptcies which originated in the United States and have since been adopted in England. Due to the stigma usually attached to reorganizations, if there is a pre-packed plan in place before the reorganization is made publicly known, this would also have the benefit of reducing the period of negative publicity which may result. Moreover, initiating a Chapter 8 Reorganization proceeding without a pre-packaged plan increases the risk of compulsory liquidation when the statutory time frame expires.

For more information on reorganizations in the PRC, please refer to the PRC chapter of the White & Case guide on Insolvency and Restructuring Procedures.

8. FerroChina: a case study

The FerroChina case is possibly the first case that involved an overseas-listed Chinese manufacturing company facing the threat of insolvency. FerroChina officially announced on October 9, 2008 that it was unable to pay RMB 706 million (approximately US\$103 million) working capital loans that had become due.

FerroChina had outstanding debts in an aggregate of about RMB 5.2 billion (approximately US\$765 million). Shortly after FerroChina's announcement of impending insolvency in October 2008, its offshore creditors appointed a receiver to take over the shares of Superb Team Limited ("**Superb Team**"), a major intermediate holding company within the FerroChina group. In addition, the offshore creditors replaced Superb Team's directors.

So far, the offshore creditors have not sought recognition by the PRC court of the offshore receiver nor have they exercised the remedy of forcing a replacement of the onshore directors. It is unclear whether the PRC court would recognize the offshore receiver in the event that the offshore creditors apply for recognition by the PRC court. Instead, the offshore creditors chose to discuss possible remedies with PRC governmental authorities (both local municipal authority and the PRC banking authority) when they took an active role in the bankruptcy process in order to prevent foreseeable unrest among FerroChina's employees and creditors. This may have been a decision on the part of the offshore creditors to help ensure that their interests would be given proper consideration if the governmental authorities were to support a private work-out protocol.

With the chances of a corporate recovery growing slim, onshore creditors filed their claims with the local PRC court and obtained court orders to freeze most of the immoveable onshore assets. Most recently, the local court in Changshu City initiated the Chapter 8 Reorganization of FerroChina's onshore entities at the request of local banks. A legal advisor was appointed as the onshore administrator (with KPMG acting as financial advisors). This deviates from past practice because in this case local banks chose to initiate the Chapter 8 Reorganization without any pre-negotiated reorganization plan. A possible reason for this may be that the creditors' pressing need to ascertain the company's financial condition outweighed the uncertainty and timing pressure imposed by a Chapter 8 Reorganization. It is also plausible that the commencement of the Chapter 8 Reorganization may give creditors access to previously unavailable financial data of FerroChina, which may in turn lead to a corporate rescue by a prospective white knight.

FerroChina has appointed a financial advisor to assist in searching for an offshore investor. Concurrently, the Chapter 8 administrator has announced at a recent creditors' meeting that it is working with Fosun International ("**Fosun**") to relaunch operations and that Fosun, a Shanghai-based conglomerate, might be interested in buying some or all of FerroChina's factories. It would be interesting to see how a potential onshore sale of assets to Fosun would impact FerroChina's ability to attract an offshore white knight investor.

Appendix 1: Enforcement Options

	Option 1	Option 2	Option 3
Description	<p>The offshore lenders take legal action in a Hong Kong court⁷ to obtain a judgment against the debtor group (including the onshore subsidiary of the borrower) in respect of a default under the credit agreement and/or letter of undertaking.</p>	<p>Taking control of the offshore borrower by the offshore lenders appointing receivers, provisional liquidators or liquidators to the offshore borrower (“insolvency representatives”). This can be achieved by the offshore lenders:</p> <p>(a) enforcing their security interest in Hong Kong by appointing a receiver; or</p> <p>(b) appointing provisional liquidators⁸ or liquidators through the Hong Kong Courts.</p>	<p>Offshore lenders directly enforcing the equity interest pledges given by the offshore borrower over its equity interest in the PRC entity (whether it be a WFOE or JV). This will enable the offshore creditors to become the owner of the PRC entity. As owner of the WFOEs, the offshore creditors can then appoint new directors, officers and/or legal representatives to the PRC entity.</p>
		<p>The primary purpose of these two options is to gain control of the equity interests of the onshore PRC entity by appointing directors, officers and/or legal representatives at the PRC entity level. The PRC government does not have any broad authority to prevent or block such a change of onshore directorship or legal representative; however, a number of issues arise with this approach.</p>	
Advantages and Disadvantages	<ul style="list-style-type: none"> ■ assets of the debtor group of any significance are likely to be situated in China (with limited assets within Hong Kong against which to enforce judgment). ■ even if there were any other assets in Hong Kong (in the form of, say, cash receipts), the Hong Kong Courts may not permit any attachment over those assets if the entity concerned is already in an insolvency proceeding in China (or elsewhere) which is recognized by Hong Kong (see <i>CCIC Finance Ltd. v Guangdong International Trust & Investment Corporation</i> [2001] HKCEA 774). 	<ul style="list-style-type: none"> ■ appointing office holders to the PRC entity will involve the local government authorities responsible for registering the change of office holder (and, if the FIE is a JV, the other joint venture party) and recognizing the powers of the insolvency representatives. 	<ul style="list-style-type: none"> ■ Where the PRC entity is a JV, care should be taken to ensure that any such action does not result in a breach of the joint venture agreement. ■ Under PRC laws, the enforcement of equity interest pledges can either be (1) by agreement or (2) through court procedures, depending on whether the offshore creditors can reach an agreement with the offshore borrower on enforcement issues. ■ Either the agreement or court procedure described above will require the approvals and registration of the approval authorities (needless to say that the court process will be even more time consuming).

7 This could apply equally to the Court of the BVI or the Cayman Islands. However, for ease of reference we have only referred to the Hong Kong court throughout this Memorandum.

8 The powers of the provisional liquidator may be limited and restricted by the Court. The powers of the provisional liquidator may include powers to carry out a corporate rescue, although recent cases have created debate as to the grounds for appointment (*See Re. Legend Resorts International Ltd* [2006] 2 HKLRD 192).

	Option 1	Option 2	Option 3
Advantages and Disadvantages (continued)	<ul style="list-style-type: none"> The offshore lenders could consider enforcing a judgment of the Hong Kong courts in China; however, enforcing a judgment in China has historically not been an easy process in practice. The Reciprocal Enforcement of Judgments Arrangement which came into force on August 1, 2008 may now make it easier. Under the Reciprocal Enforcement of Judgments Arrangement, a judgment given by a Hong Kong court is enforceable in the PRC provided that specific prerequisite conditions are met. These include, inter alia, the requirements that (i) the judgment is a final monetary judgment made by a Hong Kong court designated or recognized under the arrangement; (ii) the judgment is given pursuant to an agreement whereby the courts of Hong Kong have exclusive jurisdiction to resolve the dispute and (iii) application for registration of such judgment be made within two years from the date of the judgment. 	<ul style="list-style-type: none"> In the absence of a special treaty between PRC and the foreign jurisdiction where the offshore lenders have appointed the foreign insolvency representative (as is the case between Hong Kong and the Mainland), the PRC Courts and authorities may require the applicant to prove that appointment of the insolvency representatives was done in strict accordance with the relevant laws. Given that there are certain arrangements/agreements between HK and the Mainland regarding enforcement of court orders, a receiver appointed under Hong Kong law might have a better chance of being recognized by the PRC Courts as compared to receivers appointed in BVI or Cayman.⁹ The difficulties of obtaining recognition in the PRC by offshore insolvency representatives can be illustrated by the recent Wahaha case where receivers of the Wahaha BVI holding company appointed as a result of a dispute amongst the joint venture parties were sued by Wahaha before a PRC court for breaching PRC laws by violating Wahaha's right to do business. As a result, the receivers were fined RMB300,000 and were forced to make a public apology. 	<ul style="list-style-type: none"> In comparison to enforcement through the appointment of receivers in the offshore borrower, enforcement of the equity pledge may be a less effective method and more difficult to implement because a transfer of equity interest in an onshore company is subject to MOFCOM's approval and such approval may not be forthcoming. Enforcement of the equity pledge does not entitle the offshore lenders to foreclose the onshore company of its ownership rights or employ any other self-remedy measures.

⁹ In the FerroChina case study discussed earlier in this article, the offshore receiver has not, as at the date of this article, applied for recognition by the PRC Courts but is in active discussions with the local administrators.

	Option 1	Option 2	Option 3
Advantages and Disadvantages (continued)	<ul style="list-style-type: none"> Offshore lenders need to be aware that on a successful application to the People’s Court for a bankruptcy, reorganization or composition, an automatic moratorium arises which prohibits the continuation or commencement of all existing or pending civil proceedings against the debtor.¹⁰ Such a moratorium prevents any creditor (foreign or domestic) from enforcing a money judgment or security interest against the debtor.¹¹ A well-advised distressed FIE could try to take the initiative by applying to the People’s Court for a bankruptcy, reorganization or composition, thus invoking the moratorium. 	<ul style="list-style-type: none"> Any new directors/legal representative of the onshore company appointed by the receiver or offshore shareholder would be subject to fairly broad potential liabilities which are not limited to fines. It is not clear under PRC law whether a contractual indemnity granted by the lenders to the new directors/legal representative would be sufficient to shield them from the broad potential liabilities. Insurance coverage of directors and officers liabilities (“D&O Policies”) is permitted in the PRC. Since Chinese insurance companies normally have only very limited scope of business for such D&O Policies, the preferable approach is to maintain D&O Policies with a foreign insurer (or its branch or subsidiary in China). 	

¹⁰ During a Reorganization, enforcement of secured claims over specific assets of the debtor is suspended unless there is a danger those assets are likely to be damaged or substantially reduced in value enough to harm the interest of the holder of the security interest. In this case, the holder of the security interest may apply to the people’s court to resume enforcement of the secured claims (Article 75).

¹¹ The People’s Court shall make a ruling on whether or not to accept a bankruptcy application within 15 days from the date of receipt of such application or slightly longer if the debtor has raised an objection (Article 10). After the People’s Court has accepted a bankruptcy case, the preservation measures and the enforcement procedures in respect of the debtor’s properties shall be suspended (Article 19) and all civil litigation or arbitration proceedings in respect of the debtor’s properties shall be suspended until after the administrator has taken over the debtor’s assets when they shall resume (Article 20).

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