Asia Pacific Guide to Lending and Taking Security - China/Mainland China

If things go wrong

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# 1. Please provide a brief description of the insolvency regime. In particular what rights and duties do unsecured and secured lenders have on the insolvency of a debtor? Are there any other matters of concern?

Bankruptcy Law

The PRC Enterprise Bankruptcy Law ("**Bankruptcy Law**") came into effect on 1 June 2007.

The Bankruptcy Law introduced the following key concepts:

Voluntary and involuntary bankruptcy

An independent administrator

The involvement of creditors in the administration of the bankruptcy

Restructuring and settlement

Extraterritoriality, allowing property outside the PRC and certain foreign proceedings to fall within the regime

Voidable transactions

Ratable distribution

Grounds for bankruptcy

An enterprise qualifies for bankruptcy, restructuring or settlement under the Bankruptcy Law if one of the following occurs:

The enterprise is not able to meet its obligations to repay its debts, and its assets are less than its liabilities.

The enterprise is knowingly incapable of paying its debts.

Application to court

Bankruptcy proceedings are commenced in the people's court in the location in which the enterprise is domiciled. Either the debtor or its creditors can initiate it. If the debtor is a financial institution, the relevant regulatory authorities under the State Council file the court application.

Appointment of an administrator

On acceptance of the bankruptcy application, the court appoints a bankruptcy administrator. The bankruptcy administrator may be a member of a recognized legal, accounting or specialist bankruptcy firm, or they may otherwise possess the relevant professional expertise and qualifications.

The administrator reports to the people's court and the creditors' meeting, and the creditors' committee supervise them. The creditors' meeting can replace the administrator or seek their removal if they fail to perform their duties in a lawful and impartial manner or if the creditors' meeting decides that there are circumstances that prevent them from performing their duties competently.

Creditors' meetings

The Bankruptcy Law involves creditors in the bankruptcy process through creditors' meetings and the creditors' committee.

A creditor that has submitted a claim in bankruptcy is entitled to attend and vote at the creditors' meeting. The exception is that secured creditors cannot vote on the adoption of a settlement plan or a distribution plan of the debtor's assets unless they have waived their right to priority. Generally, a resolution of the creditors' meeting is passed by a simple majority of the creditors with voting rights that are present at the meeting and that represent 50% or more of the value of the debtor's unsecured debt.

The creditors' meeting may establish a creditors' committee that comprises creditor representatives elected by the creditors' meeting, and it must include an employee representative of the debtor or a representative of its trade union. The creditors' committee is responsible for supervising the management, disposal and distribution of the debtor's property, proposing the convening of creditors' meetings and any other duties that are delegated to the creditors' committee by the creditors' meeting.

Priority and ranking of debts

The Bankruptcy Law sets out a hierarchy of debts to determine payment priority. Payment must be made in the following descending order of priority:

Bankruptcy expenses

Common interest debts incurred for the benefit of creditors

Employee claims including unpaid salaries, medical and disability subsidies, basic old age and medical insurance premiums, and compensation in accordance with PRC law (such as compensation payable due to the early termination of an employment contract)

Social insurance premiums and outstanding tax

General or "common" unsecured claims

If the property available for distribution in the bankruptcy is insufficient to satisfy the discharge of all of the debts within a particular rank of debts, the distribution within that rank will be effected on a pro rata basis.

Secured creditors generally have priority to the extent of the value of their secured property, and any shortfall is treated as an unsecured claim.

Restructuring and settlement

The Bankruptcy Law also provides a formal process by which to restructure or rehabilitate viable businesses. Although the court may have accepted a bankruptcy application, the Bankruptcy Law allows a debtor or its creditors, prior to an enterprise being declared bankrupt, to apply to the court for the restructuring or reorganization of its business. The legislation also allows a debtor to apply for a compromise or settlement of its debts with its creditors.

# 2. Is it possible to obtain a moratorium before insolvency?

A moratorium is imposed on the debtor's assets upon the acceptance of the bankruptcy application by the court. Upon the acceptance of the bankruptcy application, all preservation measures (such as court attachments) against the debtor's property are lifted and all enforcement actions are suspended. Civil actions or arbitration procedures that have commenced against the debtor but that are not completed are stayed. Any repayment of debts to a creditor during this period is deemed invalid.

# 3. When a company is the subject of a formal insolvency procedure, can the company’s pre-insolvency transactions be set aside?

The administrator can petition the people's court to revoke the following types of transactions entered into within one year preceding the court's acceptance of the bankruptcy application:

Transfers of property for no consideration

Transactions carried out at markedly unreasonable prices

Provision of security for unsecured debts

Premature settlement of undue debts

Renouncement of creditors' claims

The administrator can also recover debts that have been repaid to individual creditors within six months prior to the acceptance of the bankruptcy petition, except where the debtor has benefited from the repayment.

Transactions that conceal or transfer assets for the purpose of avoiding liabilities, fabricating debts or acknowledging a fictitious debt would be deemed invalid under the Bankruptcy Law.

# 4. When can a lender enforce its security? Can security be enforced out of court following an event of default (or other contractual trigger event), or is a court order required? Are there any restrictions that apply before a lender may enforce its security?

Assets subject to security do not fall within the scope of bankruptcy assets. Secured creditors may exercise their security rights from the date the court approves the settlement that is part of the bankruptcy proceedings.

# 5. Do any limitation periods apply in relation to bringing an action to enforce security?

Yes, the statutory time limit in relation to the action is three years, subject to suspension and discontinuation provided by law. Calculation of the three-year period may be paused or restarted under certain circumstances. The beneficiary of the security should take legal action against the security provider within the time limit in relation to the action of the primary debt. Usually, the beneficiary of the security takes legal action against the primary obligor and security provider concurrently.

# 6. Is there any particular way in which secured assets must be liquidated on enforcement (e.g., by auction or court sale)?

No.

# 7. Are there any particular legal or practical difficulties or delays in enforcing security?

Without the cooperation of the debtor or security provider, the beneficiary will need to go through court proceedings to enforce the security.

If the debtor and the security provider fail to honor the court judgment or arbitral award after the beneficiary of the security obtains a favorable judgment or arbitral award, the creditor can apply to the court for the enforcement of the judgment or arbitral award. Typically, the court disposes of the assets by way of a public auction organized by the court. The court may request the beneficiary of the security to provide information (such as bank account details and the location of the assets) in relation to the relevant assets. This may add certain difficulties or prolong the process in relation to the enforcement, as it will take additional time for the beneficiary to collect the relevant information (which may not always be available).

# 8. In relation to enforcement, are there any specific requirements to be borne in mind if the lender is a foreign entity?

There are several specific requirements, as set out below.

Engaging PRC counsel

Procedurally, for a foreign lender to take legal action before a PRC court, it must engage a qualified PRC law firm. The power of attorney of the lender from outside the PRC for engaging the PRC law firm must be notarized and legalized1 or apostilled2 in the lender's home jurisdiction.

Language version

Court proceedings in the PRC are conducted in Chinese. Therefore, where a transaction document is prepared in English or another foreign language, a Chinese translation must be prepared and submitted to the court. Usually the people's court will require the translation to be prepared or reviewed by a third-party translation firm designated by or acceptable to the court.

Governing law

Generally, parties to a contract with a "foreign element" are allowed to choose either PRC law or foreign law as the governing law of the contract, unless otherwise provided under PRC law.

Loan documents and security documents entered into by a foreign lender are considered contracts with a "foreign element." The foreign lender may (but it is not obliged to) choose PRC law or foreign law to govern its loan and security documents to be entered into with PRC clients, except under certain PRC laws. A mortgage over property located in the PRC and any pledge over rights (such as an equity pledge, a pledge over receivables, a pledge over securities and negotiable instruments) created in the PRC must be governed by PRC law.

If the parties to a transaction document choose to have it governed by foreign law, the PRC court may still apply PRC law during the court proceedings in relation to the transaction document if it determines the following:

The parties have not provided or proved the relevant contents of the foreign law to the court.

The parties chose the foreign law to evade mandatory PRC law requirements.

The choice of the foreign law violates the social and public interests of the PRC.

Recognition and enforcement of a foreign court judgment

Under the PRC Civil Procedures Law, a foreign party seeking the recognition and enforcement of a foreign court judgment in the PRC court may perform one of the following:

Make a direct application for the recognition and enforcement of that judgment to a relevant PRC court.

Ask a foreign court to submit a request to the PRC court for the recognition and enforcement under the judicial assistance procedure.

The PRC court will only recognize and enforce a foreign judgment when both the PRC and the country where the judgment in respect of which enforcement is sought have concluded or acceded to a bilateral or international judicial assistance treaty regarding the mutual recognition and enforcement of commercial judgments, or where reciprocity can be demonstrated.

If there is no international judicial assistance treaty regarding the recognition and enforcement of commercial judgments between the PRC and the relevant country, in practice, the PRC court would only consider an application if the foreign applicant is able to prove the existence of reciprocity, i.e., that the courts of the foreign jurisdiction would enforce and have previously enforced a judgment of a PRC court. Although proof of reciprocity by the foreign plaintiff is not specifically stated in the PRC Civil Procedures Law, as a matter of practice, it appears to be a requirement of the PRC courts.

Therefore, in the PRC, it would be difficult to enforce a judgment given by a foreign court unless the PRC has concluded or acceded to a judicial assistance treaty regarding the enforcement of a commercial judgment with that foreign jurisdiction.

Recognition and enforcement of a foreign arbitral award

The PRC acceded to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards ("**New York Convention**") on 22 April 1987. The party seeking the recognition and enforcement of a foreign arbitral award in a PRC court may make a direct application to a competent PRC court within two years after the award is made. Under the notice published by the Supreme People's Court on implementing the New York Convention, the PRC court may reject the application for the recognition and enforcement of foreign awards on the following grounds, as set forth in Article V of the New York Convention:

A party to the arbitration agreement ("**Arbitration Agreement**"), under the laws applicable to it, had no capacity to enter into the Arbitration Agreement, or the Arbitration Agreement was indeed invalid under the law to which the parties are subject or, in the case where there is no express governing law of the Arbitration Agreement, the Arbitration Agreement was indeed invalid under the law of the place where the arbitration award was made.

The party against whom the application is filed was not given proper notice of the appointment of the arbitrator or was otherwise unable to present its case.

The award deals with any dispute not contemplated by or not falling within the terms of the Arbitration Agreement or the award contains decisions on matters beyond the scope of the submission to arbitration. However, if the award contains decisions on matters submitted to arbitration that can be separated from those not submitted, the part of the award that contains decisions on matters submitted to arbitration will be enforced.

The composition of the arbitral tribunal or the arbitral procedures was not in accordance with the agreement of the Arbitration Agreement or, failing that agreement, with the law of the place where the arbitration took place.

The award has not become binding on the parties, or it has been annulled or its enforcement has been suspended by the court or in accordance with the law of the place where arbitration took place.

The PRC court decides that the dispute is incapable of being settled by arbitration under the laws of the PRC.

The PRC court holds that the enforcement of the arbitration award in the PRC would be contrary to the public interests of the PRC.

For foreign arbitral awards made in a territory that is not a member of the New York Convention, the recognition and enforcement of those awards will be reviewed in light of bilateral agreements between that jurisdiction and the PRC (if any) or in light of the principle of reciprocity.

1 Applicable to documents issued in a non-contracting state of Hague Convention Abolishing the Requirement of Legalization.

2 Applicable to documents issued in a contracting state of Hague Convention Abolishing the Requirement of Legalization.

# 9. Is there any reason why you think that arbitration rather than litigation might be advantageous in resolving disputes under the finance documents, and if so, why? Please outline the relative merits of arbitration and litigation, including the ease of enforcement of foreign judgments and foreign awards from different jurisdictions. Is it possible to rely on a hybrid enforcement provision that allows the lenders to opt for either arbitration or litigation as they see fit?

In practice, in the PRC market, for most banking transaction documents (even those of foreign banks' subsidiary banks or branches in the PRC), the parties choose to have their disputes resolved by the court rather than use arbitration.

One important advantage of having a dispute resolved by the court is that if a party is not satisfied with the results of the court's judgment at the first hearing, it may appeal to a higher court for a second (and final) hearing. In arbitration, there is no second hearing. As mentioned, the enforcement of an arbitral award needs to go through the court.

In light of the above, we do not consider there to be a strong advantage in using arbitration rather than court litigation to resolve disputes under the finance documents.

Finally, the effect of a hybrid enforcement provision that provides for an option for the lenders to choose between arbitration and litigation depends on the governing law of such enforcement provision. From a PRC law perspective, a jurisdiction clause that allows for a choice between court proceedings and arbitration is invalid. Therefore, PRC courts will not recognize the effect of a hybrid enforcement provision if the parties have chosen PRC law as the governing law or the PRC courts have otherwise decided to apply PRC law to determine the effect of such provision.1

However, there is one exception to such rule in judicial practice: If a party has submitted the dispute to the selected arbitration institution based on a hybrid enforcement provision and the opposing party does not object to it before the commencement of the first hearing of the arbitration tribunal, then the arbitration tribunal will proceed with arbitration even if the jurisdiction clause is a hybrid one. Meanwhile, a hybrid enforcement provision will generally be acceptable to the PRC courts if the parties have expressly chosen a foreign law that recognizes the effect of such provision as the governing law of such provision.

1 This would usually happen if: (i) the parties have not expressly selected a governing law for the hybrid enforcement provision but have chosen a PRC arbitration institution or the PRC as the place of arbitration; or (ii) the parties have not expressly selected a governing law for the hybrid enforcement provision and have not expressly agreed on the arbitration institution or place of arbitration, but the dispute has a PRC nexus (for example, one of the parties is a PRC resident or the contract is signed within the territory of the PRC).

# 10. Are asymmetrical jurisdiction clauses enforceable? (By this we mean clauses that allow the lenders, but not the borrowers, to make certain choices in relation to choice of jurisdiction and how to litigate. These types of clauses allow the lenders, but not the borrowers, to commence proceedings in any court they choose, but restrict the borrowers to commencing proceedings in one jurisdiction only. This may also allow the lenders, but not the borrowers, to choose whether to litigate the finance documents before a court or to submit to arbitration in relation to them, but restrict the borrowers to either litigation or arbitration, as specified in the agreement).

It is not prohibited by law to document that the lenders, but not the borrowers, may commence proceedings in any court they choose but restrict the borrowers to commence proceedings in one jurisdiction only.

However, under PRC law, the parties must select in the loan agreement either court litigation or arbitration to resolve the disputes.

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