

Collection Profile China



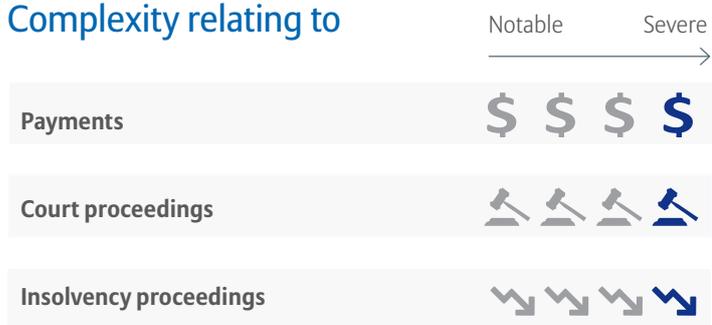
Collecting in China

- As a result of the rebalancing policy in China, direct financing or bank loans are shrinking sharply and extending to more and more sectors. Consequently, DSO remains high and late payments are not efficiently regulated.
- The court system is complex and suffers from a lack of transparency, delays and high costs. As enforcement results are poor, amicable or non-litigation collection is the preferred option.
- The insolvency framework is complex, with liquidation as the default procedure.

Collection complexity



Complexity relating to



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Contents

- General Information 3**
 - Availability of financial information..... 3
 - Main corporate structures..... 3
 - Regulatory environment..... 3

- Getting Paid..... 4**
 - Days Sales Outstanding (DSO) 4
 - Late payment interest..... 4
 - Debt collection costs..... 4
 - Ownership protection 4
 - Payments..... 4

- Collecting Overdues 5**
 - Amicable action 5
 - Legal action..... 5
 - Alternatives to legal action 7

- Handling Insolvent Debtors 7**
 - Insolvency proceedings 8



General information

Availability of financial information

As a general rule, publicly available financial information on Chinese companies is not satisfactory since, due to a lack of transparency, data rarely reflects real business situations. Only listed companies have the obligation to disclose their financial statements. For the rest, the information is either not available or not reliable. In addition, there are no restrictions on business owners starting new businesses after shutting down another without settling debts.

Euler Hermes obtains financial information from Chinese Credit Research Companies which normally cross-verify data originating from, among other sources, the State Administration for Industry and Commerce (SAIC). Euler Hermes then allocates each company a grade reflecting its financial health and how it conducts business. Grades represent a core of our knowledge and analyses, and help clients identify and avoid risk. Data is continuously monitored to offer the most up-to-date information to support management decisions.

Main corporate structures

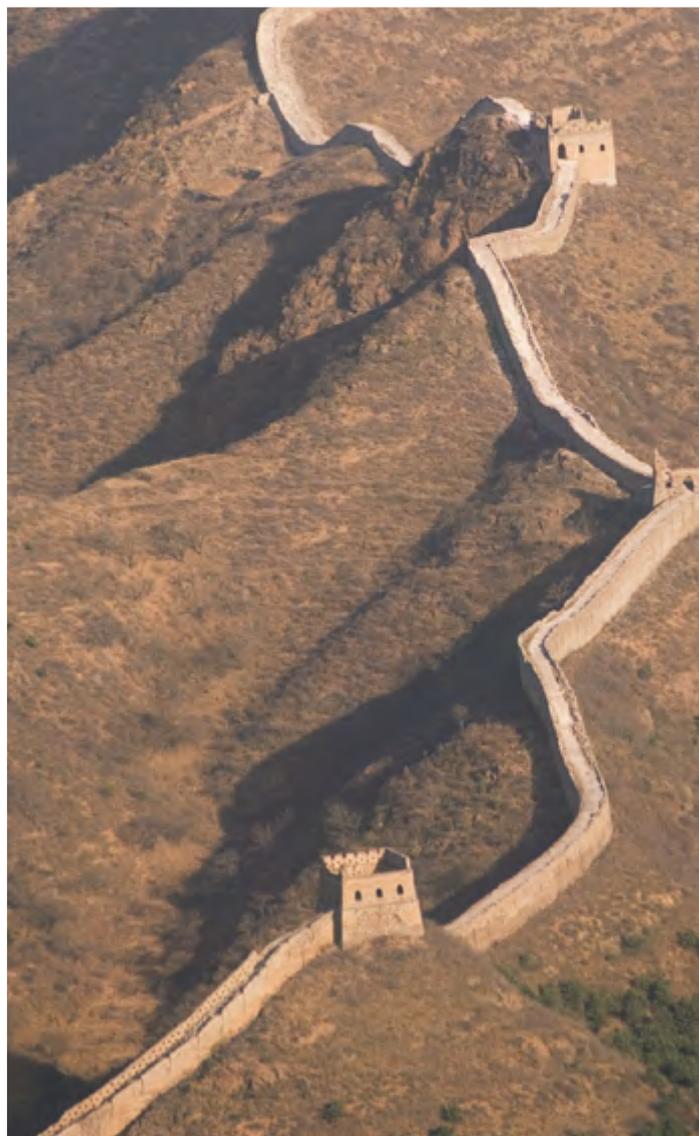
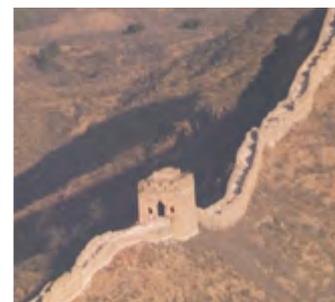
Liability for business debts is determined by legal structures, which are described as follows:

- Domestic enterprises often take the form of a Sole Proprietorship (a business entity established by assets contributed and owned by one person) or of Joint Stock Companies which rather detain capital and assets divided equally into negotiable shares (the shareholders are not liable beyond the value of their shares).
- Various business structures are also available to foreign investors. Wholly Foreign-Owned Enterprises (WFOE) are elaborated structures with limited liability. Owned by the foreign investor, they allow repatriating profits to the investor's home country. Since 2010, Foreign-Invested Partnership Enterprises (FIPE) also allow foreign investors with a limited capital to establish Partnership Enterprises in China. Representative Offices (RO) rather act as liaison offices of foreign parent companies and may only be used for specific purposes (contact liaison, market research, promotion, quality control) provided that they do not generate any revenue.
- Joint Ventures (JV) between Chinese companies and foreign investors aim at sharing investments/control, risks, and revenues in order for a foreign entity to enter a restricted market. Equity Joint Ventures are based on incorporated entities, but Contractual Joint Ventures may also be set up. In practice, companies incorporated in Hong Kong often act as Special Purpose Vehicles (SPV) to invest in mainland China.

Regulatory environment

The Chinese court system is overly complex. The courts are divided into multiple tribunals at different levels. At the lowest level, the Basic People's Courts (including County People's Courts, Municipal People's Courts, People's Courts of Autonomous Counties, and People's Courts

Days Sales Outstanding (DSO): The DSO is on a deteriorating trend, reaching 82 days compared to 73 days in 2012.



of Municipal Districts) hear criminal, administrative cases and domestic claims under RMB 50m in first instance. Intermediate People's Courts handle certain cases in first instance (including foreign-related cases and claims in excess of RMB 50m) as well as appeal proceedings brought against the decisions rendered by the Basic People's Courts. At the Central Government level, the Higher People's Courts handles interpretation issues but it may also decide on major cases in first instance.

Getting Paid

Days Sales Outstanding (DSO)

Payments terms in China fluctuate from 30 days (high-tech industry) to 120 days (commodity trading) but, the average days sales outstanding (DSO) is on a deteriorating trend reaching 82 days (compared to 73 days in 2012) despite cultural standards which do not allow taking liberties with commitments.

In most cases, overdue payment stems from financial difficulties faced by the debtor's customers (increased by weak banking support). In practice, extending payment delays therefore constitutes a frequent cash management method and Chinese companies often insist (heavily) on obtaining 120 to 180 days payment terms. Agreeing on such conditions is not advisable.

Late payment interest

Late payment interest may be charged, subject to contract terms. Calculation is made on the basis of the People's Bank of China's loan rate: 6% per year (5.6% if the overdue is below six months, 6.15% if the overdue is above one year).

If the case goes to court, most creditors/plaintiffs will charge four times the Central Bank's interest rate if late payment occurs and there is no penalty clause in the sales contract.

Interest normally serves as a negotiation tool and tends to be abandoned when a compromise is found and the debt is recovered amicably. When no compromise is reached, collection costs would however be included into the claim.

Debt collection costs

As a general rule, the law does not allow the charging of debt collection costs to the debtor and, culturally speaking, paying the debt is considered as a cost write-off. When no compromise is reached, collection costs would however be included into the claim.

Ownership protection

As a general rule, Chinese contract law provides for ownership to be transferred to the buyer upon delivery, but Retention of Title (RoT) provisions aiming at preserving ownership until the goods have been paid in full would be admissible and enforced. Extended forms of RoT preserving ownership despite transformation or sale to a third party are not possible. RoT agreements could in theory be used to take goods back during ordinary lawsuits, but would not be efficient during insolvency proceedings (see Payments).

Payments

The most common payment methods are as follows:

Swift bank transfers are among the most popular payment means as they are fast, secured, and supported by an increasingly developed banking network internationally and domestically. In the case of companies located outside of China and exporting into China, transfers are usually guaranteed through an Export Credit Insurance policy, which helps minimize the risk of sudden or unexpected customer insolvency. Euler Hermes' risk experts in China monitor the financial well-being of our clients' counterparties in China and grant them specific credit limits up to which they may trade and claim should something go wrong. Credit insurance for domestic trade within China is growing and increasing in popularity among Chinese corporates, and Euler Hermes – in partnership with selected local insurers – supports clients in China trading domestically throughout the country. Alternatively, Standby Letters of Credit (a bank guarantees the debtor's credit quality and repayment abilities) constitute reliable guarantees which can be interpreted as a sign of good faith since they can be triggered as a 'payment of last resort' if the client fails to fulfil a contractual commitment. Also, irrevocable and confirmed Documentary Letters of Credit (a debtor guarantees that a certain amount of money is made available to a beneficiary through a bank once certain terms specifically agreed by the parties have been met) may be considered.



Late payment interest:
6% per year may be charged based on the People's Bank of China's rate.



Checks are very common. However, since the import regulations of 2010, Standby Letters of Credit and Documentary Credits are increasingly difficult to obtain while banks habituated to deal with foreign currencies must register guarantees with the State Administration of Foreign Exchange. As a result, 20% to 25% of international transactions are now being paid partly (up to 10% by law) in advance. It should also be emphasized that local banks tend to read Documentary Credit terms in a creative manner, while interpretation by domestic tribunals differs significantly from the recommendations formulated by the International Chamber of Commerce.

Collecting overdues

Amicable action

Negotiating

The key to amicable collection in China is expertise in the market and knowing what can be leveraged to draw the debtor back to negotiation as dunning letters are not very effective. Before starting legal proceedings against a debtor, assessment of assets is important as it allows verification as to whether the company is still active, whether recovery chances are at best, and improves chances of enforcement. In addition, it is essential to be aware of the debtor's solvency status: if insolvency proceedings have been initiated, it indeed becomes extremely difficult to enforce a debt.

Legal action

Ordinary proceedings

If the amicable phase fails or if the debtor questions the claim, the option of starting legal proceedings remains. If the debt is undisputed, it is possible to start a pre-court procedure (PRC Civil procedure law no. 189) requesting a Payment Order from the Basic People's Court, enforceable for 15 calendar days upon service to the debtor if the latter fails to obey and does not bring a defense. If the debtor brings a counterclaim, the case must however be dealt with through ordinary court proceedings. Proceedings would occur as follows: once a claim is filed, the competent court would conduct a preliminary examination to determine whether the case ought to be accepted. The court would then examine the evidence and invite the parties to reach a compromise prior to rendering its decision. Remedies ordered by the court would normally take the form of compensatory damages, orders towards the elimination of detrimental effects, cessation of infringements, etc. Specific performance may also be ordered. Punitive damages are however not admissible.

Necessary documents

According to the Civil Procedure Law of China, the necessary documents for credit-related disputes include: a comprehensive



complaint, a list of evidence, the business license of each party, contracts, delivery orders, invoices, related correspondences, collaterals/guarantee letters and all other related evidence.

Time limitations

As a general rule, claims must be brought to court within specified time limitations which start running from the moment the claimant is (or should have been) aware of the facts justifying the claim. Administrative disputes against public authorities must be brought within three months. Commercial claims must be brought within two years (up to four years when technology transfers and international sales of goods are involved). Claims related to carriage of goods by sea must be brought within one year from the (effective or expected) delivery date, against 180 days for claims related to carriage of goods by train. Applications for protection of civil rights must be brought within two years. Applications for cases dealing with substandard goods, rent payment issues, physical injuries, etc. must be brought within one year. Beyond these time limitations, legal action will not be granted.

Collection @ Euler Hermes

It is always advised to attempt collection prior to any legal action in order to maximize chances of successful recovery and avoid legal costs and delays. Our key principle is to collect in close proximity to the debtor, using a series of letters, emails and phone calls in the local debtor language. Our World Collection Network of Euler Hermes offices and external providers are experts in professional trade debt collection and negotiation, ensuring positive outcomes while retaining important client relationships. Euler Hermes can handle the complete collections process from amicable, pre-legal action through to judgment and enforcement.

Precautionary measures

Precautionary measures may help preserve the creditor's interests pending a final and enforceable judgment. Indeed, the courts may order pre-action remedies to avoid irreparable damage and preserve the status quo (preventive attachment of bank accounts and property, sealing of plants, custody of stocks, prohibition to execute an act or contract) or to protect evidence.

The claimant would be required to file a motivated request demonstrating the urgent and absolute necessity of granting such an injunction, and the court would most likely request for security on costs to be provided in order to protect the debtor from irresponsible action. To protect or obtain evidence, specific requests should be applied to the court but these would not fall under the scope of application of precautionary measures.

Lodging an appeal

The parties are entitled to bring decisions rendered in first instance to the Superior People's Court within 15 days, but it is necessary to file a petition for this purpose. The decision rendered in second instance would deal with matters of facts or law, and is deemed final. The only solution for a dissatisfied party would be to file for a retrial on different grounds.

Enforcing court decisions

In theory, the defeated party must comply with a final decision. Otherwise, the claimant may apply for execution with the People's Court or with an Execution Officer. In this case, the court may order the freezing of the debtor's assets or accounts. In practice, enforcing a court judgment or an arbitral award in China can be difficult.

Another solution is to obtain enforceable decisions through the Hong Kong courts, under the Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters (REJA) of 2006. Hong Kong has an efficient legal system independent from the Chinese courts and REJA allows Hong Kong Courts to enforce decisions in mainland China. As a result, Hong Kong has long been the preferred jurisdiction for contracts involving foreign and Chinese parties and remains the best venue to enforce decisions in China. Garnishee Orders are admissible in China and enforceable towards a third party debtor. If a debtor fails to execute the judgment, the creditor should immediately ask for enforcement. To use the Hong Kong courts, contracts and terms and conditions should state that all disputes are to be resolved exclusively by the Hong Kong courts. Legal advice should be considered. To enhance the enforcement procedure, especially with regards to personal guarantee, the China Supreme Court released a Notice of the Supreme People's Court on the application of law regarding the failure to follow the court verdict (2015 No.16) effective since 22 July 2015. With this notice it is hoped that overall enforcement results will improve and a personal guarantee will be more useful for the creditor. One key condition for enforcement in China is clue of assets which may be discovered by the Court or Creditors. Whenever additional assets are found, an immediate request should be made to the court for enforcement.

How long could legal action take?

By law, first instance decisions ought to be rendered within six months of acceptance of the case by the court but proceedings would be much longer when various creditors are involved or the case has a fraudulent dimension. Appeal proceedings must be terminated within three months after appeal acceptance. Enforcement usually takes six months but can take two years in domestic disputes. When enforcement with a foreign dimension is concerned, see the previous points. In practice, the courts are entitled to extend time requirements for complex cases, which can reach two years before a decision is rendered, or much longer when a foreign party is involved.

How much could this cost?

As a general rule, the successful party may request the court that the defeated party pays for the court fees as well as collection, legal and enforcement costs (from 2% to 15% of the claim). Court fees will be charged when filing petition, while the rate is from 2.5% (CNY 10~100k part) to 0.5% (beyond CNY 20m) depending on the amounts at stake, with a minimum RMB 50 fee.

Conditional arrangements, whereby attorneys are not paid upfront but rather receive a fixed sum upon success, and contingent fees, whereby the legal professionals are entitled to receiving a percentage on the final award, are authorized by law in business disputes.



Litigation @ Euler Hermes

Should legal action be necessary, Euler Hermes can provide support throughout the legal process from judgment to enforcement via our World Collection Network of Euler Hermes offices and external providers. Legal action can often be complicated and expensive, so you will be informed of all costs prior to any action and advised on which route is best to take.

Alternatives to legal action

Alternative Dispute Resolution methods (ADR)

As domestic tribunals are uncertain, arbitration increasingly helps to solve disputes in a peaceful and confidential manner, but in practice the execution of settlement agreements sometimes remains unreliable.

Foreign forums

As a consequence of the lack of reliability of domestic courts, disputes tend to be resolved through a foreign forum. Applying Swiss business law in Sino-Foreign contracts is sometimes recommended as it is perceived as being neutral. In practice, most contracts may be governed by the law selected by the parties with the exception of Joint Venture contracts and share transfer contracts which must be governed by Chinese law. Having said this, domestic courts can have difficulties enforcing foreign law and going through Hong Kong Courts under REJA is the best way to obtain enforcement (see below). Subjecting the contract to Hong Kong law could therefore seem preferable. Seeking specialized legal advice on this point should not be considered optional.

Enforcing foreign awards

Enforcing foreign awards in China may prove difficult, but not to say impossible. As most countries, China requires that foreign judgments be recognized through exequatur proceedings in order to become enforceable. In practice, however, China only has reciprocal enforcement agreements with a couple of former communist countries, while domestic courts are protectionist and tend to make exequatur proceedings extremely lengthy and costly. As a result, although suing Chinese debtors abroad is always possible, attempts to enforce foreign decisions in China would most likely be a waste of time (and money). As previously mentioned, using Hong Kong Courts under the REJA of 2006 would be an effective way to obtain results for commercial matters, as these would be able to obtain enforcement of foreign awards in mainland China. In practice, and provided that the contract is subject to the exclusive jurisdiction of Hong Kong Courts, the Hong Kong High Court would render a decision and issue Summons through the High Court in Shanghai, which would then recognize the award under REJA (without being able to review the case on its merits) and enforce it. China is a signatory to the New York Convention on the Recognition and Enforcement of Foreign Arbitral Awards of 1958, meaning that Chinese courts ought to recognize and enforce awards rendered through international arbitration proceedings. Therefore, international arbitration could also constitute a significant alternative to ordinary legal proceedings.

Handling insolvent debtors

Insolvency in China is a matter of cash flow and balance sheet alike: a debtor is deemed insolvent when it is illiquid, i.e. when it is permanently unable to pay its outstanding debts, but illiquidity may also be characterized when the debtor's liquidated assets cannot

satisfy all the creditors. Both tests must be satisfied prior to filing for bankruptcy.

According to the new Enterprise Bankruptcy Law of 2006 (inspired from international standards), restructuring, liquidation and compromise are available for companies in financial difficulties. The Supreme People's Court in June 2009 furthermore provided guidance, saying that enterprises with viable future prospects and in line with the national structural adjustment policy should be actively supported through restructuring and compromise procedures. In addition, it seems that local governments can use stability maintenance funds or encourage third parties to provide interim financing. Having said this, it is not obvious whether these regulatory efforts are efficient, and it actually seems that they are not relied upon in practice.

Proceedings would usually take place before the Peoples Courts' (economic divisions) of the debtor's region, but in practice compromise rarely applies and restructuring or liquidation are traditionally relied upon.

The years 1996 to 2003 witnessed a peak time during which the government let a lot of state-owned companies go bankrupt as a means to clear up bad assets. This policy was efficient at the time however, since then companies have rarely made efforts to go through insolvency proceedings and simply tend to disappear. As a result, the recovery ratio from insolvency procedure overall seems very limited and it is essential to provide the best efforts in order to settle any dispute prior to reaching insolvency.

However, more companies are being put through the insolvency procedure by local government due to complexities in labor issues and banking requirements. Whereas related practices like tracing illegal assets transfer and owner's liability are not applied. When comparing justice to protection of credits, China courts are more concerned with social stability (labor arrangement) and the speed of case closure.





Insolvency proceedings

Out-of-Court proceedings

The new law also authorizes the debtor to seek a compromise with the creditors in order to settle liabilities. The agreement must be approved by two-thirds of the unsecured creditors. The court will rule to acknowledge the conciliation agreement (which is thus binding), but it may also declare the debtor bankrupt if no compromise is found.

Restructuring the debt

Reorganization proceedings allow a debtor to submit a debt restructuring plan to its creditors. The plan must be approved by each creditor class (employees, secured creditors, tax claims, ordinary claims, etc.) before being validated by the court. The debtor is then responsible for implementing the plan under the supervision of an administrator. The parties are bound, and a moratorium is set up to stay parallel enforcement proceedings. If the plan is deemed unviable, however, the court orders the company's liquidation.

In practice, insolvency litigations are rarely solved through debt-restructuring proceedings and liquidation remains the default procedure in China.

Winding up proceedings

If the court accepts a bankruptcy petition (initiated by the debtor or by its creditors), the creditors must file their claims with the court during a specific period of time (up to three months) imposed by the court. All claims against the debtor are then temporarily suspended until an administrator takes control of the company and liquidates its assets, under the supervision of the Creditors' Committee. If the debtor is deemed untrustworthy, the court may order a Property Preservation Order.

Priority rules

Unsecured creditors may enforce their rights as long as no insolvency proceedings have been opened. Once insolvency proceedings commence, the law gives priority to bankruptcy proceeding-related costs, and to the secured creditors. The proceeds of the debtor's

liquidation would then be used to cover bankruptcy procedural costs, employment-related costs (wages, tax), and fiscal debts. Unsecured creditors would come last.

There is no official registry for security interests (such as RoT clauses), therefore priority issues must be dealt with before the court if necessary.

Cancellation of suspect transactions (clawback)

The administrator would usually be entitled to either continue or discharge performance of any transaction entered into with creditors, within one year prior to the acceptance of the application for insolvency. In particular, misplaced property transfers, unreasonable transactions giving an unfair advantage to one creditor over the others, etc. would typically be void.

In practice, parties to which notice of the acceptance of the application for bankruptcy has not been given within two months may consider that their contract could be discharged.

How long could insolvency proceedings take?

Insolvency proceedings would typically take between two and four years, but when the debtor does not have sufficient assets the court would immediately terminate the proceedings.

Necessary documents

Claimant's and debtor's register information, application form indicating requests and reasons, evidence of credit (VAT, contract, delivery orders, correspondences etc.), statement of account and collaterals if any.

Insolvency @ Euler Hermes

Euler Hermes works closely with debtors, creditors and lawyers to provide support during insolvency and restructuring processes. With many options available when it comes to insolvency action, we can offer advice on which option is most suitable.

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