SPC Guiding Case No. 163: Substantive Consolidation Bankruptcy Reorganization of Jiangsu Textile Industry (Group) Import & Export Co., Ltd. and Its Five Subsidiaries

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Keywords

Civil / bankruptcy reorganization / substantive consolidation bankruptcy / affiliated enterprises / debt-to-equity swap / pre-vote

Holding

1. Where a party applies for consolidated bankruptcy of affiliated enterprises, the people's court shall examine the necessity and legitimacy of the consolidated bankruptcy. The bankruptcy of affiliated enterprise members shall, in principle, be conducted by applying a single bankruptcy procedure to each; where there is a high degree of commingling of corporate personality among the affiliated enterprise members, the cost of distinguishing the property of each affiliated enterprise member is excessively high, and the fair satisfaction interests of creditors are seriously harmed, the people's court may, upon application, exceptionally conduct the trial by way of substantive consolidation bankruptcy of the affiliated enterprises.

2. Where the method of substantive consolidation bankruptcy is adopted, the claims and debts among the affiliated enterprise members shall be extinguished, and the property of each member shall become the unified bankruptcy property after consolidation, with the creditors of each member being fairly satisfied as a whole in the same procedure in accordance with the statutory order of satisfaction. After consolidated reorganization, the affiliated enterprises shall in principle be merged into a single enterprise; however, if the creditors' meeting votes for the continued existence of each affiliated enterprise and the people's court, upon examination, finds that there is indeed a need, it may approve it.

3. In consolidated reorganization, the formulation of the draft reorganization plan shall comprehensively consider such factors as the assets and operational advantages of the affiliated enterprises entering the consolidation, the satisfaction ratio of creditors after consolidation, and the adjustment of the equity interests of contributors, so as to safeguard the lawful rights and interests of all parties; at the same time, satisfaction schemes such as "cash plus debt-to-equity swap" may be flexibly designed, and creditors' opinions may be solicited in advance by way of "pre-vote," on the basis of which the reorganization plan may be improved, so as to promote the smooth progress of the reorganization.

Basic Facts

Applicants: the joint administrator of Jiangsu Textile Industry (Group) Import & Export Co., Ltd., Jiangsu Textile Industry (Group) Light Textile Import & Export Co., Ltd., Jiangsu Textile Industry (Group) Knitting Import & Export Co., Ltd., Jiangsu Textile Industry (Group) Mechanical and Electrical Import & Export Co., Ltd., Wuxi Xinsufang International Trading Co., Ltd., and Jiangsu Textile Industry (Group) Garment Import & Export Co., Ltd.

Respondents: Jiangsu Textile Industry (Group) Import & Export Co., Ltd., Jiangsu Textile Industry (Group) Light Textile Import & Export Co., Ltd., Jiangsu Textile Industry (Group) Knitting Import & Export Co., Ltd., Jiangsu Textile Industry (Group) Mechanical and Electrical Import & Export Co., Ltd., Wuxi Xinsufang International Trading Co., Ltd., and Jiangsu Textile Industry (Group) Garment Import & Export Co., Ltd.

On January 24, 2017, the Intermediate People's Court of Nanjing ("Nanjing Intermediate Court"), upon the application of Zhenjiang Fuyuan Textile Technology Co., Ltd., ruled to accept the bankruptcy reorganization case of Jiangsu Textile Industry (Group) Import & Export Co., Ltd. ("Provincial Textile Import & Export Company"), and on the same day appointed Jiangsu Dongheng Law Firm as the administrator. On June 14, 2017, the Nanjing Intermediate Court ruled to accept the reorganization applications filed by the Provincial Textile Import & Export Company against Jiangsu Textile Industry (Group) Light Textile Import & Export Co., Ltd. ("Provincial Light Textile Company"), Jiangsu Textile Industry (Group) Knitting Import & Export Co., Ltd. ("Provincial Knitting Company"), Jiangsu Textile Industry (Group) Mechanical and Electrical Import & Export Co., Ltd. ("Provincial Mechanical and Electrical Company"), and Wuxi Xinsufang International Trading Co., Ltd. ("Wuxi Xinsufang Company"), and the reorganization application filed by the Provincial Light Textile Company against Jiangsu Textile Industry (Group) Garment Import & Export Co., Ltd. ("Provincial Garment Company") (among these, the reorganization application filed by the Provincial Textile Import & Export Company against Wuxi Xinsufang Company was, upon instruction from the Higher People's Court of Jiangsu Province, designated to be under the jurisdiction of the Nanjing Intermediate Court). On the same day, the Nanjing Intermediate Court appointed Jiangsu Dongheng Law Firm as the administrator and coordinated the trial of the six companies procedurally. On August 11, 2017, the administrator, on the ground that the personalities of the six companies — the Provincial Textile Import & Export Company, the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company — were highly commingled, applied to the Nanjing Intermediate Court for substantive consolidation reorganization of the six companies.

The court found upon trial:

I. The shareholding of the six companies in issue

The registered capital of the Provincial Textile Import & Export Company was RMB 55 million, of which Jiangsu Textile (Group) Corporation ("Provincial Textile Group") contributed 60.71% and the company's labor union contributed 39.29%. The registered capital of the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company (the "five subsidiaries") was RMB 10 million, RMB 5 million, RMB 6.37 million, RMB 10 million, and RMB 10 million respectively; the Provincial Textile Import & Export Company contributed 51% in each of the five subsidiaries, and the remaining shares of the five subsidiaries were all held by employees.

II. The operation and management of the six companies in issue

1. Except for Wuxi Xinsufang Company, the companies in issue were all registered at the same address; their legal representatives held overlapping positions, and the legal representatives of the five subsidiaries were all senior management personnel of the Provincial Textile Import & Export Company; financial personnel and administrative personnel were also shared, with the five subsidiaries sharing financial personnel with the Provincial Textile Import & Export Company for accounting, and the final approvers of payments and reimbursements were the same persons.

2. There was business cross-commingling between the Provincial Textile Import & Export Company and the five subsidiaries; the business of the five subsidiaries was specifically arranged by the Provincial Textile Import & Export Company, and there were a large number of related debts and guarantees between the Provincial Textile Import & Export Company and the five subsidiaries.

In order to prevent the arbitrary consolidation of affiliated enterprises, which would harm the independent personality of companies and the lawful rights and interests of some creditors and other interested parties, after receiving the consolidated reorganization application, the Nanjing Intermediate Court examined the application matters and factual grounds put forward by the applicant, and at the same time organized creditor representatives, debtor representatives, employee representatives, the administrator, and audit

institutions to conduct a comprehensive hearing, listened to the statements of all parties on whether there were facts of commingling of the companies, and conducted a comprehensive review of the claims and debts sorted out by the administrator, the audit reports, and the evidence submitted by all parties, and listened to the opinions of all parties on the consolidated bankruptcy reorganization.

Judgment

In accordance with Articles 1 and 2 of the Enterprise Bankruptcy Law, the Nanjing Intermediate Court rendered Civil Ruling (2017) Su 01 Po No. 1, 6, 7, 8, 9, 10 on September 29, 2017: the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company shall undergo consolidated reorganization with the Provincial Textile Import & Export Company.

In accordance with Article 86, paragraph 2 of the Enterprise Bankruptcy Law, the Nanjing Intermediate Court rendered Civil Ruling No. 2 of (2017) Su 01 Po No. 1, 6, 7, 8, 9, 10 on December 8, 2017: 1. approve the consolidated reorganization plan of the Provincial Textile Import & Export Company, the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company; 2. terminate the consolidated reorganization procedure of the Provincial Textile Import & Export Company, the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company.

Reasoning

The effective judgment held: the independence of corporate personality is the cornerstone of the company system, and the bankruptcy of affiliated enterprise members shall also, in principle, be conducted by applying a single bankruptcy procedure to each. However, where there is a high degree of commingling of corporate personality among the affiliated enterprise members, the cost of distinguishing the property of each affiliated enterprise member is excessively high, and the fair satisfaction interests of creditors are seriously harmed, the method of substantive consolidation bankruptcy of the affiliated enterprises may be applied for trial, thereby safeguarding the fair satisfaction of all creditors.

In this case, the six companies in issue exhibited a high degree of commingling of personality, mainly manifested in: highly overlapping personnel appointments without the formation of complete and independent organizational structures; sharing financial and approval personnel without an independent financial accounting system; highly cross-commingled business, forming a highly commingled business entity, which objectively made it difficult to properly distinguish the revenues of the six companies; and a large number of related debts and guarantees among the six companies, causing the assets of each company to be unable to be completely independent and making the sorting out of claims and debts extremely difficult. In these circumstances, the court held that the timely substantive consolidation of the affiliated enterprises conformed to the Bankruptcy Law's requirements of the principles of fairly sorting out claims and debts and fairly protecting the lawful rights and interests of creditors and debtors. The legislative purpose of the Enterprise Bankruptcy Law is to regulate bankruptcy procedures, fairly sort out claims and debts, fairly protect the lawful rights and interests of all creditors and debtors, and thereby maintain the order of the socialist market economy. Where affiliated enterprises exhibit high commingling of personality and improper benefit transfers, this not only seriously affects the fair satisfaction of the creditors of each affiliated enterprise but also seriously affects the fair competition principle of the socialist market economy, fundamentally violating the substantive spirit of the Enterprise Bankruptcy Law. In these circumstances, conducting consolidated reorganization of affiliated enterprises with high commingling of personality, correcting the illegal and non-compliant conduct of affiliated enterprises such as improper benefit transfers and mutual control, and safeguarding the fair realization of the claims of the creditors of each affiliated enterprise conform to legal provisions. Specifically with respect to creditors, under separate reorganization, the ordinary creditors of an affiliated enterprise that is in substance an enterprise receiving benefit inputs

would obtain additional satisfaction, while the ordinary creditors of an affiliated enterprise that is in substance an enterprise making benefit outputs might suffer losses. Therefore, where the corporate personalities of affiliated enterprises are highly commingled, separate reorganization may cause harm to the ordinary creditors' right to fair satisfaction. After consolidated reorganization as a whole, the claim satisfaction ratio of the creditors of some affiliated enterprises whose book assets are advantageous may be lower than under separate reorganization, causing their interests to appear superficially harmed, but the root cause of this difference lies in the prior improper affiliated relationships among the affiliated enterprises; carrying out debt satisfaction through consolidated reorganization is precisely a reflection of the Enterprise Bankruptcy Law's fair sorting out of claims and debts.

In accordance with Articles 1 and 2 of the Enterprise Bankruptcy Law, the Nanjing Intermediate Court rendered Civil Ruling (2017) Su 01 Po No. 1, 6, 7, 8, 9, 10 on September 29, 2017: the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company shall undergo consolidated reorganization with the Provincial Textile Import & Export Company.

After the consolidated reorganization procedure was initiated, the administrator conducted consolidated handling of the claims of the individual enterprises. Where the same creditor had both claims and debts against the six companies, the claim balance was confirmed after offsetting through consolidation; the claims and debts among the six affiliated enterprises were offset in the consolidation; and all creditors after consolidation were grouped as a whole. According to the Bankruptcy Law, creditors are divided into the property-secured claim group, the employee claim group, the tax claim group, and the ordinary claim group. In this case, because the labor relations of all employees continued to be retained, the issue of satisfaction of employee claims was not involved, and the taxes had been paid on time, so the creditors were only divided into the property-secured claim group and the ordinary claim group. At the same time, a contributor group was established to vote on the contributor equity adjustment plan.

In view of the fact that the Provincial Textile Import & Export Company, as a textile foreign-trade enterprise with relatively high influence within the province, possessed high-quality operating qualifications and resources, and that the five subsidiaries were important platforms of the foreign-trade enterprise, the reorganization plan took the six companies, including the Provincial Textile Import & Export Company, as a whole, introduced investors, and comprehensively considered such factors as the assets and operational advantages of the companies entering the consolidation, the satisfaction of creditors after consolidation, and the adjustment of contributor equity interests, and designed and formulated it comprehensively. The key contents included:

I. Introducing high-quality assets for restructuring to revitalize the enterprise's operations. Before entering the reorganization procedure, the six companies in issue had already fallen into a serious operating crisis, and the key to whether the reorganization could succeed lay in whether the enterprise's operations could be truly revitalized. Based on this, this case introduced companies such as Suhao Holdings and the Provincial Textile Group as reorganization investors, increasing the capital of the Provincial Textile Import & Export Company by nearly RMB 1.2 billion with high-quality assets such as shares in listed companies they held. Through the timely injection of high-quality assets to restructure the enterprise, new economic growth factors were formed, the overall resources of the affiliated enterprises were revitalized, the debt satisfaction capability was improved, and the enterprise's operating capability was restored, laying a solid foundation for reshaping the enterprise's core competitiveness and smoothly promoting the execution of the reorganization plan. At the same time, as a foreign-trade enterprise, the retention of employees is an important guarantee for the enterprise's ability to be reborn. In formulating the reorganization plan, based on the characteristics of the foreign-trade enterprise, all employees were retained, and through the injection of employee equity, the synergy and guarantee of enterprise operations were formed, thereby ensuring that the enterprise after successful reorganization could truly be reborn.

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II. Adjusting contributor equity interests, uniformly satisfying debts by way of “cash plus debt-to-equity swap,” and introducing a “pre-vote” mechanism. The six companies in issue were all foreign-trade companies with few self-owned assets. In terms of the debt satisfaction method, part of the enterprise assets were first disposed of to provide a source of debt satisfaction funds. In terms of the satisfaction method, a unified distinction was made between property-secured and non-property-secured creditors. For property-secured creditors, based on the value of the secured property already disposed of in the reorganization procedure and the appraised value of the undisposed secured property, the amount of priority satisfaction of the property-secured creditors was determined, and the property-secured creditors were satisfied in full in cash. For ordinary creditors without property security, a composite satisfaction method of partial cash satisfaction and partial satisfaction by exchanging equity for claims (debt-to-equity swap) was adopted, safeguarding the enterprise’s hematopoiesis and rebirth capability and maximizing the protection of creditors’ interests. Among these, part of the equity of the capital-increasing shareholders was exchanged with the creditors’ claims (the debt-to-equity swap portion). Specifically, the reorganization investor, the Provincial Textile Group, transferred part of its shares in the Provincial Textile Import & Export Company to the administrator to satisfy the creditors’ claims by proportional exchange, and the Provincial Textile Group released the Provincial Textile Import & Export Company and the five subsidiaries from the debts arising from the exchange that they owed to it. After the satisfaction was completed, the creditors waived all remaining claims against the Provincial Textile Import & Export Company and the five subsidiaries. Because the composite satisfaction method of “cash plus debt-to-equity swap” was adopted, whether the creditors were willing to be satisfied in this way was the key to whether the reorganization could succeed. Therefore, this case introduced a “pre-vote” mechanism: in formulating the draft reorganization plan, the administrator gave a prior explanation of the necessity, feasibility, and specific satisfaction method of the debt-to-equity swap, and the creditors issued written opinions in advance, on the basis of which the draft reorganization plan was improved and then submitted to the creditors’ meeting for deliberation and vote. Judging from the effect, satisfying debts by way of “debt-to-equity swap” and conducting a pre-vote during the formulation of the reorganization plan better safeguarded the creditors’ right to know and right to choose and their ability to independently express opinions, thereby enabling the smooth implementation of the “debt-to-equity swap” satisfaction method.

On November 22, 2017, the first creditors’ meeting was held after the consolidated reorganization of the six companies in issue. The administrator submitted the draft consolidated reorganization plan to the creditors’ meeting, and the affiliated enterprises continued to exist. Upon vote, the property-secured claim group approved by 100%, the ordinary claim group approved the draft plan by 93.6%, and the contributor group meeting also approved the contributor equity adjustment plan by 100%. Upon examination, the court held that the formulation and voting procedures of the consolidated reorganization plan were lawful, the content conformed to legal provisions, creditors were treated fairly, the adjustment of contributor equity interests was fair and just, and the operating plan was feasible. In accordance with Article 86, paragraph 2 of the Enterprise Bankruptcy Law of the People’s Republic of China, the Nanjing Intermediate Court rendered Civil Ruling No. 2 of (2017) Su 01 Po No. 1, 6, 7, 8, 9, 10 on December 8, 2017: 1. approve the consolidated reorganization plan of the Provincial Textile Import & Export Company, the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company; 2. terminate the consolidated reorganization procedure of the Provincial Textile Import & Export Company, the Provincial Light Textile Company, the Provincial Knitting Company, the Provincial Mechanical and Electrical Company, Wuxi Xinsufang Company, and the Provincial Garment Company.

Relevant Legal Provisions

Articles 1 and 2 of the Enterprise Bankruptcy Law of the People’s Republic of China.

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