

Recent Supreme Court Notice – Potential effect on the adoption of Close-out Netting in China

The Supreme Court issued a series of bankruptcy-related judicial rules recently in order to streamline and standardize bankruptcy proceedings in Mainland China. In particular, the *Supreme Court's Notice on Certain Issues regarding Registration and Acceptance of Bankruptcy Petitions* (the “**Supreme Court Notice**”), which became effective as of 1 August 2016,¹ has the effect of facilitating the adoption of close-out netting under Mainland China law.

Background

Following the Supreme Court's Interpretation on the Bankruptcy Law in 2013, it became clear that the right of a party to net values arising from terminated transactions would be an enforceable self help remedy within the purview of bankruptcy set-off in the bankruptcy proceedings of its Mainland China counterparty.² This left the key question of whether the right of such party to terminate/close out transactions under any derivatives master agreement is also enforceable. Given that a right to terminate/close out transactions would be subject to a stay after the acceptance of a bankruptcy petition by the court under article 18 of the Enterprise Bankruptcy Law (the “**Bankruptcy Law**”), some participants have opted to “switch on” automatic early termination (“**AET**”) provision with respect to their China counterparties so that all transactions would be automatically terminated before the acceptance of a bankruptcy petition by the court.

To do so, participants would modify the AET provision in the ISDA Master Agreement (or the onshore NAFMII Agreement) by removing the retroactive effect of the AET provision so that all transactions are terminated automatically upon the filing of the bankruptcy petition.³ Another consequential change is the removal of the 15-day grace period in Section

¹ Note that the Supreme Court Notice (Zui Gao Fa Ming Chuan [2016] No.469) only became available on public sources from September 2016.

² Please refer to our previous bulletin dated 10 February 2014 – *China - The New Netting Jurisdiction*

³ The original AET is retroactive in that it deems, when a bankruptcy petition resulted in a bankruptcy order or was not dismissed within a 15-day grace period, the termination to occur “immediately preceding” the filing of a bankruptcy petition. See the 2014 China Netting Memorandum published by ISDA for further details on the enforceability of AET provision and recommendation for removing the retroactive effect of AET provisions.

Contents

Background.....	1
Clarifications brought by the Supreme Court Notice	2
<i>Introduction of the Supreme Court Notice</i>	2
<i>Requirement for facts and reasons</i>	3
<i>Requirement for other matters a court determines to be necessary</i>	3
<i>Implications of the Supreme Court Notice</i>	3
Looking forward	4

5(a)(vii) of the ISDA Master Agreement (or Section 6.8.5 of the NAFMII Master Agreement) as, with AET occurring on the filing of a bankruptcy petition, this becomes redundant.

However, there has been some concerns from counterparties in Mainland China about such modified AET provisions (“**modified AET provisions**”) in that, if the retroactive effect of the AET and the 15-day grace period were removed, AET may be triggered prematurely by a frivolous bankruptcy filing from third party creditors.

Clarifications brought by the Supreme Court Notice

Introduction of the Supreme Court Notice

The Supreme Court Notice, when read together with the Bankruptcy Law and judicial practices in Mainland China, would mean that a bankruptcy petition will only be filed successfully upon the court making certain determinations and thus that the concerns relating to modified AET provisions will no longer be valid.

Pursuant to the Supreme Court Notice, it is now clear that the mere presentation of a bankruptcy petition by a third party creditor does not mean the petition would be automatically filed with the court. It is true that the court will, upon presentation of a bankruptcy petition by a third party creditor to the court, issue a receipt to the creditor.⁴ However, the issuance of such court receipt only acknowledges the receipt of the relevant materials by the court and does not evidence the filing of a bankruptcy petition. A bankruptcy petition can only be considered as filed if the court, after review, registers the petition and assigns a case number to the petition which starts with “Po Shen” (破申).⁵

Whilst such review is provided to be a review of form,⁶ the court is required to ensure that all the requirements provided in article 8 of the Bankruptcy Law have been satisfied before it can register the bankruptcy petition.⁷ Specifically, article 8 states that a third party petitioning creditor shall provide the following information in the petition for the court’s review:

- (i) basic information about the creditor and the debtor;
- (ii) the purpose of the bankruptcy petition;
- (iii) facts and reasons for such petition; and
- (iv) any other matters a court determines to be necessary.

⁴ Article 2 of the Supreme Court Notice.

⁵ Article 2 of the Supreme Court Notice.

⁶ This is a “review of form” where the court will ascertain whether there are prima facie grounds to make out a case for bankruptcy. Substantive verification of facts and evidence as well as adjudication of the petition (including submission from the debtor company) will be conducted by the court later when it decides whether to accept or reject the petition.

⁷ Article 2 of the Supreme Court Notice.

Requirement for facts and reasons in (iii)

Understandably, the creditor is required to provide facts and reasons of its bankruptcy petition. In other words, before the court determines whether or not to allow a bankruptcy petition to be filed, it has to make an initial assessment on whether the petition has valid grounds. In particular, given that the pre-condition for filing a bankruptcy petition is that the relevant debtor is unable to pay its due debt, a petitioning creditor must at a minimum indicate the debtor's inability to pay the applicable debt when due.⁸ If the facts and reasons provided by the creditor are not sufficient to support the bankruptcy petition, it is likely that a court would reject the filing of such petition or require the creditor to provide further and better information.

It is reasonable to assume that the information provided by the third party creditor to the court will be accurate as lying to a court could result in serious economic or administrative penalties and even criminal liabilities.

Accordingly, this requirement alone may filter out frivolous or vexatious petitions.

Requirement for other matters a court determines to be necessary in (iv)

In addition, the creditor is also required to provide or comply with "any other matters a court determines to be necessary". This requirement provides the courts with further discretion in evaluating a bankruptcy petition and requiring further information to be furnished. We understand that, for example, a court may, where the debtor is a major listed company with a large number of employees and stakeholders, require some form of contingency plan to be put in place for the purpose of maintaining good order and stability. When a relevant debtor is a regulated entity (e.g. a commercial bank or systematically important institution), we understand that the court may also require evidence showing that the relevant regulator (e.g., the China Banking Regulatory Commission in the case of a bank) has been consulted and does not have any objection to the petition. This is understandable since, from a policy perspective, Mainland China courts are very cautious in initiating any bankruptcy procedures against a substantial regulated entity in order to ensure and maintain financial stability and good social order.

Implications of the Supreme Court Notice

In light of the above, a Mainland China counterparty should no longer be overly concerned with the modified AET provisions since it is very unlikely that an AET would be triggered by a frivolous or vexatious bankruptcy petition.

That said, to avoid giving any impression that AET would be triggered upon the mere presentation of a bankruptcy petition, parties should consider

⁸ This would be the case when the debtor has admitted its inability to pay debt or does not dispute the debt which has fallen due. If there were any dispute on the debt, the court would likely consider the right course of action to be for the creditor to take a civil action for recovering the debt or for breach of contract rather than a bankruptcy action.

amending the AET provisions in the relevant master agreement to ensure that the trigger point for AET is the point where the bankruptcy petition has been successfully registered with the court and not the mere presentation of bankruptcy petition.

Looking Forward

With the issuance of the Supreme Court Notice, it appears that modified AET provisions can indeed be included into ISDA Master Agreement, NAFMII Master Agreement or any other applicable master agreement to facilitate close-out netting without causing a premature trigger of the termination under such agreement. The Supreme Court Notice has made it clear that concerns regarding premature termination are unnecessary as the courts will conduct an assessment of any bankruptcy petition before registering the petition. This is particularly the case where the relevant Mainland China counterparty is a bank or other substantial, regulated entity in Mainland China since the court has wide power to screen out any frivolous and vexatious petitions.

This development is extremely timely: with the implementation of margin rules globally imminent, market participants are engaged in the process of reaching out to their Mainland China counterparties to negotiate regulatory-compliant new ISDA Credit Support Annexes or comparable collateral arrangements.

Authors: Linklaters

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Contacts

For further information please contact:

Chin-Chong Liew
Partner

(+852) 2842 4857/
(+86 10) 6535 0630

chin-chong.liew@linklaters.com

Simon Zhang
Counsel

(+852) 2842 4844/
(+86 10) 6535 0688

simon.zhang@linklaters.com

Stephen Song
Managing Associate

(+852) 2901 5440

stephen.song@linklaters.com

Wayne Huang
Managing Associate

(+852) 2901 5432/
(+86 10) 6535 0674

wayne.huang@linklaters.com

Leo Pan
Managing Associate

(+852) 2901 5436

leo.pan@linklaters.com

Ying Zhou
Associate

(+852) 2842 4153/
(+86 10) 6535 0682

ying.zhou@linklaters.com

Jodie Cheng
Associate

(+852) 2901 5221/
(+86 10) 6535 0490

jodie.cheng@linklaters.com

Chris Wang
Trainee Solicitor

(+852) 2901 5272

chris.d.wang@linklaters.com