What happens on the outsourcer’s insolvency: a comparison of relevant insolvency principles in the US, India and China

Michael Murphy, Joshua Konvisser and Yusuf Safdari
Pillsbury Winthrop Shaw Pittman LLP

Nishith Desai
Nishith Desai Associates

Joseph Chan
Sidley Austin*

Following the global economic downturn, companies have been faced with the possibility that key outsourced services may suffer, or even disappear, if an external service provider becomes insolvent. Insolvency of a service provider also raises other tangential issues, such as recruitment of the service provider’s personnel and ownership of, and access to, intellectual property (IP), inventory and equipment. With a significant percentage of outsourcing services becoming globalised, formerly domestic services are now provided from delivery centres in the Americas, Asia and Eastern Europe, and the work is becoming increasingly mobile. Although there are many viable locations for global service delivery, a significant proportion of services provided to US-domiciled outsourcing customers now comes from India and China. The leading India- and China-headquartered outsourcing companies are also expanding direct operations into other countries.

Against this background, US-based outsourcing customers must assess the legal, financial and operational risks of multinational outsourcing. This article outlines the US bankruptcy law principles and issues that are most relevant for customers of insolvent outsourcing service providers. It then provides a comparison of those principles with the insolvency frameworks in India and China.

If an outsourcing supplier enters into a formal insolvency proceeding, or if an insolvency proceeding appears imminent, the customer has several questions to answer:

- What effect does the proceeding have on the customer’s rights of self-help under its service agreement, such as termination rights, step-in rights, asset purchase rights, access to escrowed materials, and the right to remove services from the service provider’s control?
- What steps should the customer take to protect its interests before and during the bankruptcy proceeding?

OVERVIEW OF THE RELEVANT US INSOLVENCY LAW

In the US, insolvent companies typically resort to two forms of bankruptcy administration under Title 11 of the United States Code (Bankruptcy Code):

- Liquidation under Chapter 7.
- Reorganisation under Chapter 11.

US District Courts have subject-matter jurisdiction over bankruptcy cases. However, these cases are referred to specialised Bankruptcy Courts for administration.

In a Chapter 7 liquidation proceeding, the bankrupt entity (usually referred to as the debtor) ceases operations and an independent bankruptcy trustee takes custody of the debtor’s non-exempt assets, sells those assets and distributes the proceeds to creditors. In a Chapter 11 reorganisation, by contrast, the entity often remains as a going concern, normally under the control of the debtor’s pre-existing management. The debtor, with court supervision, attempts to reorganise its operations and repay its creditors. Following an exclusivity period during which only the debtor may propose a reorganisation plan, any interested party can propose such a plan. The law sets specific requirements for a reorganisation plan to be confirmed and implemented. Once the plan is approved by the creditors and the court, the plan is binding and regulates the handling of all debtor’s debts and business operations.

Given the recent number of high-profile Chapter 11 reorganisation proceedings involving large enterprises, this article focuses on the features of a Chapter 11 reorganisation that are particularly relevant to an outsourcing relationship. The article then compares these features with the equivalent frameworks in India and China.
Automatic stay

Filing a bankruptcy petition triggers an automatic stay that bars the commencement, enforcement or appeal of proceedings that seek to control property of, or exercise remedies against, the bankruptcy estate (such as lawsuits and repossessions) (Bankruptcy Code § 362). However, a secured creditor may seek relief from the stay in order to pursue its state law rights against its collateral or may seek relief from the stay as a way to force a debtor to make interim payments to the secured creditor as a condition to the stay remaining in effect.

Further, the stay and related Bankruptcy Code provisions bar counterparties to an executory contract (that is, a contract where both parties have ongoing material performance obligations) from terminating the contract or conditioned future performance on the debtor’s payment of pre-petition debt. Most outsourcing agreements qualify as executory contracts. Therefore, once the bankruptcy petition is filed and the automatic stay takes effect, the outsourcing customer may not exercise any rights it may have had under its outsourcing contract to withdraw from the outsourcing relationship. Typical withdrawal rights include:

- Termination rights.
- Purchase options over the factors of production (computing equipment, facilities and so on).
- The right to solicit the outsourcing supplier’s staff.
- The right to take assignments of licences to third-party software and IP.

Effectively, the outsourcing customer is locked in the contract until the debtor decides how to proceed.

Rejection, assumption and assignment of executory contracts

The debtor (service provider) can reject burdensome executory contracts, while assuming beneficial or valuable contracts (Bankruptcy Code § 365). By rejecting a contract, the debtor can stop performance under the contract with little notice (sometimes as short as ten to 20 days). If the debtor rejects a contract, the rejection is deemed a breach of the contract (not its termination) and the counterparty’s claim for damages becomes a general unsecured claim against the debtor’s estate, likely to be paid at a fraction of its full value. Contract rejection may force the customer to find another supplier or in-source the outsourced function, and the customer may have difficulty enforcing transition assistance obligations from the bankrupt supplier with respect to that function (notwithstanding any contractual rights to the contrary). The bankruptcy court may enforce transition assistance obligations if the cost to the estate of breaching those obligations is greater than the cost of compliance.

Alternatively, the debtor can elect to retain or assume the contract. Beneficial contracts may also be assigned to third parties in certain circumstances. Before assuming or assigning a contract, the debtor must both:

- Cure all defaults by paying the counterparty’s claim in full (for example, by repaying any pre-petition obligations such as overcharges or performance credits arising from default on one or more service levels).
- Provide adequate assurance of future performance under such contract.

Severability of contracts

Generally, the debtor must assume or reject each executory contract in its entirety. For example, a debtor cannot assume certain provisions of a contract while rejecting others. If, however, a contract comprises several economically interdependent agreements, the debtor may attempt to sever the agreement and assume or reject each component independently, thereby retaining the profitable and rejecting the unprofitable components. In determining whether obligations in a contract are severable, courts typically look to state law to determine whether the obligations are economically interdependent. For example, severability was allowed where two contracts had different nature and purpose, and the parties’ obligations were not interrelated (see In re Gardiniер, Inc., 831 F.2d 974 (11th Cir 1987)).

In outsourcing transactions, contracts are frequently structured as master service agreements with components of services contracted through separate statements of work. These agreements are often favoured by customers because they are flexible and are designed to create severable, independent service relationships with separate pricing, service levels and scopes of work. Examples include separate scopes of work for IT infrastructure services, application support services, project services and customer support services. In a bankruptcy, this structure may expose the customer to service continuity risk if the debtor elects to assume some and reject other statements of work, thereby forcing the customer to accept an incomplete service package with potentially serious gaps in service. The customer would then have to fill the gaps on a piecemeal basis that may be far from optimal and more costly. To mitigate this risk, a customer may include in its master service agreement an acknowledgment of the interdependence of the statements of work (if any) and an express provision that the statements of work are intended to form an integrated (non-severable) service offering.

Similar issues can arise with software licensing arrangements. Software licensees also frequently execute separate documents to license software and to obtain associated software maintenance services. Although the licensee may believe that this arrangement constitutes a single commercial transaction, the separate documents may permit the licensor to terminate software maintenance services without terminating the licence.

IP licences

If the debtor is a licensor and rejects an IP licence (including trade secrets, patents or copyright, but excluding trade marks), the licensee can elect either to treat the licence as terminated or to retain the rights under the licence as they existed immediately before the petition was filed (Bankruptcy Code § 365(n)). If the licensee elects to retain its IP licence rights, it must continue to pay royalties to the debtor-licensor and may enforce any exclusivity provisions. The licensee, however, is not entitled to any post-petition updates or improvements to the IP, or to specific performance of any other components of the licence agreement (for example, maintenance). Therefore, a software licensee will have a licence to use the software for the duration of its licence.
period, but will not be entitled to ongoing support of the product by the licensor/debtor. Therefore, although the Bankruptcy Code provides some protection for non-debtor licensees, the protection may be limited in practice.

Debtor’s management retains control
Importantly for an outsourcing customer, the debtor’s management remains in control of the bankrupt entity’s operations during the continuance of a Chapter 11 bankruptcy. As a result, existing lines of communication and informal dispute escalation can remain intact, and the customer may be able to gain insights into the operational implications of the bankruptcy by communicating closely with the supplier’s executive management.

Preferential transfers
To preserve the priority of creditors, courts can avoid certain transfers of the debtor’s property that take place within a specified amount of time (typically 90 days, but up to one year for transfers made to company “insiders”) before the filing of the bankruptcy petition (Bankruptcy Code § 547(b)). This rule generally applies to any improvement in the customer’s position that is created within the specified period. For example, if prior to the bankruptcy filing the parties agree to a new performance credit regime whereby the customer can recover credits that did not previously exist under the contract, the debtor may be able to claw back the credits if the agreement was outside the ordinary course of dealing. However, the preferential transfers rule does not cover:

- Transfers in the ordinary course of business.
- Transfers that constitute a contemporaneous exchange of equivalent value.
- Transfers that are made according to a pre-existing contract (for example, payment of pre-negotiated performance credits).

Proofs of claim
Under Chapter 11, the debtor must file a schedule of all of its known assets and liabilities with the bankruptcy court, noting the name of the creditor and the amount and status of the anticipated claim. Creditors should check to ensure that their claims are listed. The listed creditors will receive a notice from the debtor or the court of the commencement of the bankruptcy case. Only those creditors whose debts are not scheduled, or whose debts are scheduled as disputed, contingent or unliquidated, must file a proof of claim before a court deadline (the bar date). If a creditor disputes the amount scheduled or intends to assert an un-scheduled claim, the creditor must file a proof of claim before the bar date. A proof of claim, which requires adherence to a simple form, should include a brief description of the facts giving rise to the claim and the supporting documentation. The court will treat the claim as prima facie valid unless challenged by the debtor.

Set-off rights
The Bankruptcy Code preserves a party’s right to set off, subject to applicable state law. Therefore, depending on the applicable state law, the outsourcing customer may be able to set off a pre-petition monetary claim (for example, for overbilling) against pre-petition unpaid service invoices due to the service provider (Bankruptcy Code § 553). However, the customer must seek court permission before doing so or risk violating the automatic stay.

OVERVIEW OF THE RELEVANT INDIAN INSOLVENCY LAW

The Indian statutory framework for liquidation of insolvent companies is most similar, in effect, to Chapter 7 of the US Bankruptcy Code. There is no equivalent of the US Chapter 11 bankruptcy proceeding that would ordinarily apply to an outsourcing supplier in India. However, an Indian outsourcing supplier may have other options to restructure or reorganise its operations, such as a court-assisted compromise and arrangement with creditors or, if it is a publicly listed company, a bailout takeover. Each of these options combines statutory law, common law and commercial custom, with significant differences from the US law and practice.

Liquidation
Indian law regulates both voluntary and involuntary winding-up of insolvent companies. In the context of a liquidation, a company is deemed “insolvent” when it is unable to pay its debts (Indian Companies Act 1956 (Companies Act) §§ 433-34). Liquidation proceedings are regulated by Part VII of the Companies Act. The High Court has jurisdiction in relation to liquidation matters. To notify all creditors and interested parties involved in a liquidation proceeding, the insolvent company must state that it is being wound up in each outgoing invoice, order or letter (Companies Act § 547(1)).

Although Indian liquidation law and procedure embody concepts that are broadly similar to the US insolvency law and procedure, there are important distinctions. For example, the automatic stay in India generally comes into effect only on the date when the court grants a petition to liquidate the company, rather than the filing date of the petition seeking liquidation (as would be the case in the US). However, a creditor may obtain a court-ordered stay before a final winding-up order by applying to the court (Companies Act § 442). For example, a creditor may succeed in obtaining a stay to prevent an outsourcing customer from obtaining a pre-liquidation advantage from the insolvent company, such as by drawing down on a letter of credit to fund performance-related damages or credits that are owed to the outsourcing customer. From the Indian law perspective, acts such as drawing down on a letter of credit change the insolvent company’s liability profile, thereby providing a valid rationale for granting the stay.

However, a stay is unlikely to interfere with a contractual right to terminate an outsourcing agreement. By contrast with the US law, an outsourcing customer is not necessarily “trapped” in its outsourcing contract pending the outcome of the Indian insolvency proceeding. Depending on the circumstances, an outsourcing customer may benefit significantly from the flexibility to terminate its contract with an Indian outsourcing company. In essence, an outsourcing customer does not need to passively await a decision by an official Indian liquidator to accept or reject its contract.

On ordering a winding up, the court generally appoints an official liquidator (usually a government official or a professional firm) to take custody of the company’s property, effects and actionable claims (Companies Act § 456). The court may order that certain
persons or entities affirmatively deliver money or property to the liquidator and may authorise the liquidator to take custody of money and property to which an insolvent company is prima facie entitled (Companies Act § 468). Further, the official liquidator can invalidate certain transfers of the debtor's assets, including payments in cash, that take place up to 12 months before either (Companies Act § 531):

- The court grants a petition to wind up.
- In the case of a voluntary winding-up, the passing of a resolution (that is, the decision to wind up is not pursuant to a court order).

Therefore, an outsourcing customer negotiating a claim with an Indian outsourcing company that may be or is insolvent should be aware that a settlement payment can be avoided by the liquidator if it is both (Companies Act § 531):

- Made within the 12-month period before the liquidation order.
- Not made in the ordinary course of business, in good faith and for valuable consideration.

It is therefore important to demonstrate adequate consideration and good faith for any settlement or determination of disputed claims if the outsourcing service provider is bordering on insolvency.

Further, the official liquidator may (subject to court approval) reject any unprofitable contract entered into by the insolvent company up to 12 months after the winding-up process begins (Companies Act § 535(1)(d)). If the party to a contract requests in writing that the liquidator decides whether or not to reject a contract, the liquidator must respond within 28 days (subject to court extension) or the contract will be deemed upheld. Alternatively, the party to a contract with the insolvent company can petition the court to terminate the contract while leaving intact its rights as a bankruptcy creditor with respect to any breach resulting in damages (Companies Act §§ 535(4)-(5)).

Priority of the repayment of certain classes of debt is generally consistent with US law. Subject to certain government claims (that is, if a statute expressly creates a “first charge” over the asset in favour of the government (Central Bank of India v State of Kerala (2009) 4SCC 94)) all claims are paid in the following order:

- Costs related to the winding-up process.
- Secured claims and employee claims.
- Floating charges.
- Unsecured claims.

**Compromise and arrangement**

As an alternative to liquidation, an insolvent company may seek to enter into a compromise and arrangement with its creditors. The compromise and arrangement is negotiated between the insolvent company and a supermajority of its creditors (see below). It is binding on all creditors if it is approved by both:

- A creditor supermajority that represents 75% or more of the value of the creditors’ claims or class of creditors, as the case may be.
- The court.

On application by the insolvent company the court may oversee the compromise and arrangement process and, in its discretion and if it considers it appropriate, order the company's liquidation (for example, if the compromise is unsustainable or cannot be reached with a supermajority of creditors) (Companies Act §§ 391-392). An outsourcing customer with a significant interest at stake may wish to be represented during the compromise and arrangement process, to ensure that its opinion is heard.

**Sick Companies Act**

The Sick Industrial Companies Act 1985 (SICA) seeks to afford “sick” companies (see below) an opportunity for rehabilitation under the supervision of a designated Indian governmental agency. SICA applies only to companies that have existed for at least five years. Under SICA, an industrial company is sick when it either accumulates losses that equal or exceed its entire net worth at the end of the financial year, or experiences a 50% erosion of its peak net-worth for the preceding four years. Sick companies must refer themselves to the Indian National Board for Industrial and Financial Reconstruction (Board) within 60 days after finishing the company’s duly audited accounts for that year. Alternatively, the government may refer the company to the Board if it believes that a company has become sick.

The Board determines whether the sick company can survive as a going concern and, if so, develops a rehabilitation plan. The review process can reportedly take up to two years. An automatic stay applies during the review period. In addition, the Board makes an inventory of assets and liabilities and creates a list of interested parties, including creditors and shareholders. The Board has broad authority to:

- Restructure operations.
- Sell or lease assets.
- Force the sale of the company.
- Reject contractual arrangements.

If the Board determines that the sick company cannot continue as a going concern, then it refers it to a court for liquidation.

However, SICA does not apply to a typical outsourcing company that provides services. SICA applies only to certain types of manufacturing companies specified in the First Schedule to the Industries (Development and Regulation) Act 1951 (section 1(4), SICA). It does not cover services-oriented companies such as a typical Indian software and business process outsourcing (BPO) companies.
The bailout takeover

Tech Mahindra’s acquisition of Satyam Computer Services Pvt. Ltd. (Satyam) illustrates another potential route for a troubled Indian outsourcing company. In the case of Satyam, the Indian government took control of Satyam pursuant to Section 408 of the Companies Act. That Section permits the government to take control of an Indian company plagued by fraud and oppression of shareholders. After taking control of Satyam, the government appointed a new board of directors and evaluated strategic alternatives for the company. Eventually, the government passed emergency legislation which allowed it to implement a takeover of Satyam by Tech Mahindra following a bidding contest. As a publicly listed company, Satyam was able to utilise an amended form of the Takeover Regulations (see below). The amendments made it easier for Tech Mahindra to complete the takeover. In the absence of these amendments, the takeover of Satyam on an Indian public exchange would have been difficult.

Chapter IV of the Securities and Exchange Board of India Regulations (Acquisition of Shares and Takeover) 1997 (Takeover Regulations) provide for bailout takeovers of listed companies. The main purpose of the Takeover Regulations is to enable a weak company (that is, a company which has, at the end of the previous financial year, accumulated losses that led to the erosion of more than 50% but less than 100% of the company’s net worth) to sell itself and avoid winding-up. Under the Takeover Regulations, the potential acquirer of a financially weak company is exempted from the application of Chapter III of the Takeover Regulations. Chapter III imposes a number of onerous disclosure and challenging procedural requirements when a party intends to acquire shares of any listed company beyond certain prescribed ownership thresholds.

In addition to less strict requirements under the Takeover Regulations, the Satyam “forced sale” further benefited from special supplementary emergency legislation and rulemaking. The Securities and Exchange Board of India (SEBI) promulgated a Takeover Code amendment under which SEBI provided additional assistance to Tech Mahindra by barring any competitive bid once Tech Mahindra made its public bid for shares of Satyam.

The Satyam takeover illustrates how a customer of a listed Indian outsourcing company may find itself in a relationship with a third party acquirer. Therefore, an outsourcing customer may want to ensure that its contract with the supplier has appropriate change of control provisions to protect it from an outsourcing contract without liability or give it bargaining leverage to renegotiate in the event that its original outsourcing supplier is taken over by another Indian company.

Comparison with the US

The principal similarities and differences between the Indian insolvency law and a US proceeding are as follows:

- **Automatic stay.** After an Indian court has granted an order to wind up, an automatic stay comes into force on all pending or subsequently initiated legal proceedings (Companies Act § 446). Unlike under the US law, the stay does not ordinarily bar a contractual counterparty (such as an outsourcing customer) from exercising a right of termination, but it does prevent certain other self-help measures (see above). Further, a stay under Indian law takes effect much later in the process than the automatic stay under the US bankruptcy law.

- **Rejection of executory contracts.** The concept of rejection of executory contracts by the insolvent company is recognised under Indian law only after an official liquidator takes charge. Therefore, an insolvent company subject to winding-up has no inherent right to reject any contract validly in existence. After appointment, the official liquidator typically has the power to either reject or uphold a contract (Companies Act § 457 (1)(b)). In contrast with the US law, an outsourcing customer is likely to have the option to terminate a contract under its termination provisions even if the Indian outsourcing company is in the middle of liquidation.

- **Severability of contracts.** Indian law does not explicitly recognise the severability of contracts. Therefore, the right to terminate an existing contract is likely to be controlled by the termination section or related provisions of the outsourcing agreement.

- **IP licences.** If an insolvent Indian company subject to winding-up owns IP, the IP is deemed the company’s asset that must be transferred to the official liquidator after the court orders a winding-up of the company. The official liquidator is likely to sell the IP along with other assets. However, if the insolvent company holds an IP licence, then a licensor may seek to terminate it with the official liquidator’s permission. If the outsourcing customer is the licensee, an official liquidator may be able to continue or terminate the licence. Therefore, it may be in the best interests of an outsourcing customer to specify in the outsourcing contract the process if an Indian outsourcing company enters a contractually defined “zone of insolvency”. For example, the outsourcing contract may require the outsourcing company to sell the IP for a fixed price under specified conditions.

- **Debtor’s management.** Under US law, the debtor’s management in a Chapter 11 proceeding typically retains control of the company to ensure preservation of existing relationships and continuity of communication with shareholders and other interested parties. In an Indian liquidation, all powers and functions of the board of directors and management transfer to the official liquidator who then assumes full control over the company. In an arrangement and compromise, the board remains in control, potentially subject to court oversight.

- **Voidable transfers.** Indian law provides for the recovery of preferential payments in a manner similar to US law, but within different time frames (see above).

- **Proof of claims.** In India creditors must provide sufficient proof of their claims on the debtor’s insolvency (section 474, Companies Act). This stands in contrast to US law where a creditor must only prove its claim if the debtor does not list the claim as required by law or if the creditor intends to contest the amount.
OVERVIEW OF THE RELEVANT CHINESE INSOLVENCY LAW

China has adopted many bankruptcy concepts from US law but there are some notable differences.

On 1 June 2007, the Enterprise Bankruptcy Law (Bankruptcy Law) came into effect, resulting in significant changes to China’s bankruptcy scheme. Under the new system, local courts of first instance (referred to as People’s Courts) have jurisdiction over bankruptcy matters. There is no specialised bankruptcy court unlike the US. The Bankruptcy Law generally applies to all insolvent commercial legal entities, whether privately owned or state-owned (Article 2, Bankruptcy Law). Jurisdiction over bankruptcy cases rests with the court of the place where the insolvent enterprise is domiciled (Article 3, Bankruptcy Law).

Three procedures are available under the Chinese bankruptcy regime:

- Liquidation.
- Reorganisation.
- Conciliation.

A debtor may petition for liquidation, reorganisation or conciliation if the debtor is unable to pay its debts as they become due (cash flow test) and either (Article 3, Bankruptcy Law):
  - The total liabilities of the debtor exceed the value of its assets; or
  - The debtor “obviously lacks liquidity” (this is not defined in the statute).

In contrast, creditors may petition for reorganisation or liquidation if the debtor is unable to pay its debts as they fall due (Article 7, Bankruptcy Law).

Common features

Several features of the Bankruptcy Law are common to liquidations, reorganisations and (in some cases) conciliations:

- Appointment of an administrator. The Bankruptcy Law adopts an administrator regime. An administrator is similar to a trustee in the US but, unlike the US, is present in all three types of proceedings. An administrator is appointed by a court when the court decides to accept a bankruptcy petition (Article 13, Bankruptcy Law). The administrator is drawn from a pool of officially sanctioned administrators, which typically include law firms, accounting firms and bankruptcy liquidation firms. An administrator’s functions include ascertaining, collecting and disposing of the debtor’s assets and participating in proceedings on the debtor’s behalf. An administrator in China is also active in reorganisation cases until the reorganisation plan is sanctioned by the court and becomes effective.

During the interim period and subject to the court’s approval, the debtor’s board and management may continue to manage the estate under the supervision of the administrator. This is similar to the “debtor in possession” scheme in the US.

- Stay of proceedings. During liquidation, reorganisation or conciliation, the Bankruptcy Law provides for a stay of proceedings against the debtor, but on a more limited basis than in the US. Unlike the practice in the US where a stay is triggered on the filing of a bankruptcy petition, formal adjudication is necessary in China (Article 10, Bankruptcy Law). A stay only commences after the acceptance of a petition by the court. When the court accepts a bankruptcy petition, all measures to preserve the debtor’s estate are released and all enforcement proceedings terminated (Article 18, Bankruptcy Law), except for civil or arbitral proceedings initiated before the commencement of bankruptcy, which may resume after the appointment of an administrator.

- Customer cannot terminate. The court stay prevents the exercise of a termination right by a customer under an outsourcing agreement. However, the customer may require the administrator to elect whether or not to terminate the contract. If the administrator fails to respond within 30 days, the contract is deemed terminated. If the administrator elects to continue an executory contract, the customer may demand collateral in support of the contract. If the administrator fails to provide collateral, the contract is deemed terminated (Article 18, Bankruptcy Law). However, it is not clear whether a customer can insist on specific collateral or even collateral of a certain value, nor is it clear how the collateral is to be held.

Liquidation

Features of the liquidation process that are particularly relevant to outsourcing transactions are as follows:

- Payments. When the bankruptcy petition is accepted, subsequent payments to individual creditors are prohibited and void (Article 16, Bankruptcy Law). Immature claims are deemed to become due when the court accepts the bankruptcy petition, at which point interest stops accruing on debts (Article 46, Bankruptcy Law). Debts owed to the debtor must be paid to the administrator rather than to the debtor (Article 17, Bankruptcy Law). Set-off is stayed until the administrator authorises it (Article 40, Bankruptcy Law). New civil proceedings may be brought but only in the same court that accepts the bankruptcy petition (Article 21, Bankruptcy Law).

- Assumption and rejection of contracts. The administrator may assume or reject an executory contract, but must do so within two months of the acceptance of a petition (Article 18, Bankruptcy Law). As a result, an outsourcing customer must wait for the administrator’s decision as to whether to assume or reject an executory outsourcing contract but can expedite the process by requesting a decision from the administrator (see below). The customer cannot refuse to continue with a contract.

- Voidable payments and transfers. Similar to a trustee in the US, an administrator has avoidance powers to recover assets transferred during certain specified time frames before the acceptance of a petition. These avoidable transfers fall under two categories:
• debt payments made during the six months before
the acceptance of the petition and during the debtor’s
insolvency. (The settlement of a customer’s claim for
non-performance under an outsourcing agreement
may fall within this six-month window and subject to
recapture if the debtor was insolvent at the time of the
settlement.) (Article 31, Bankruptcy Law);
• transfers indicative of fraud made during the one year
before the acceptance (Article 32, Bankruptcy Law).

Creditor representation. Creditors may choose to establish a
creditors’ committee composed of creditors’ representatives
and one representative from the debtor’s employee or labour
union, up to a maximum of nine members (Article 67,
Bankruptcy Law). The creditors’ committee, if formed, may,
among other things, supervise the administrator’s manage-
ment of the debtor’s assets and the distribution of liquida-
tion proceeds (Article 68, Bankruptcy Law). The adminis-
trator reports to the committee when undertaking material
actions concerning the estate. If a creditors’ committee is
not formed, the administrator reports to the People’s Court
(Article 69, Bankruptcy Law).

Priority of claims. Secured creditors retain priority with
respect to secured assets. Outstanding amounts of secured
claims are treated as unsecured debts (Articles 109-110,
Bankruptcy Law). Employment-related claims rank higher
than secured claims if they accrue before 27 August 2006
(the promulgation date of the Bankruptcy Law) (Article 132,
Bankruptcy Law). Unsecured claims are paid in the follow-
ing order (Article 113, Bankruptcy Law):
• workers’ compensation claims;
• social insurance and tax claims;
• general unsecured claims.

Bankruptcy administrative expenses and debts incurred for
common benefit (for example, debts incurred from voluntary
service to the estate) are discharged from the estate as
they arise, with the former taking precedence over the
latter, should the estate be insufficient to pay both types
of expenses (Articles 41-43, Bankruptcy Law). Bankruptcy
administrative costs include such expenses as those
incurred in the litigation, administration, appraisal and
distribution of the bankruptcy estate.

Set-off rights. Creditors may assert a right of set-off against
the administrator with respect to amounts owed to the
debtor. This is an important right for outsourcing customers
with contracts that provide liquidated damages or perform-
ance credits for service defaults (Article 40, Bankruptcy
Law). However, this set-off right is unavailable if (Article
40, Bankruptcy Law):
• the set-off claim arises after the court accepts the
bankruptcy petition;
• the creditor knows the debtor is insolvent when the
creditor incurs debt to the debtor, unless due to opera-
tion of law or facts that occurs one year before the
bankruptcy petition;
• the creditor, which was already a debtor to the debtor,
knows the debtor is insolvent at the time the credi-
tor becomes a creditor to the debtor, unless due to
operation of law or facts that occur one year before the
bankruptcy petition.

These rules are intended to prevent creditors from obtaining an
advantage over other creditors by using knowledge in relation to
the debtor’s financial status.

Reorganisation

The reorganisation framework contained in the Bankruptcy Law is
similar to the US Chapter 11 proceeding. The debtor, its creditors
or the debtor’s equity holders holding more than a 10% interest
may apply to a court to commence a reorganisation proceeding
(Article 70, Bankruptcy Law). If the court accepts the petition,
an administrator is appointed and a reorganisation plan must be
produced by the debtor or the administrator within six months.
The deadline to submit a reorganisation plan may be extended
for an additional three months for cause (Article 79, Bankruptcy
Law). The law does not define cause, but the courts seem rather
liberal in interpreting the meaning of that term, as long as it can
be shown to benefit the proceeding. Once the reorganisation plan
is approved by the creditors and sanctioned by the court, the plan
is carried out by the debtor.

If a plan is not submitted on time, the reorganisation is terminated
and a liquidation proceeding follows (Article 79, Bankruptcy
Law). The Bankruptcy Law does not provide a mechanism for
submission of a competing plan by creditors or shareholders. The
court convenes a creditors’ meeting to review the reorganisation
plan within 30 days of receipt of the plan (Article 84, Bankruptcy
Law). The plan must be approved by a simple majority of creditors
holding at least two-thirds of the total debt in each class (that is,
secured creditors, unsecured creditors, tax and work entitlement
claimants) present at the creditors’ meeting (Articles 82 and 84,
Bankruptcy Law).

The Bankruptcy Law also provides for a “cram down”. The court
can approve a reorganisation plan irrespective of the dissent of a
creditors’ class, if the following conditions are met:
• The plan is feasible.
• The secured creditors, workers and tax authorities are either
not negatively affected or have voted in favour of the plan.
• The unsecured creditors will be not worse off than if the
debtor goes into liquidation.
• The adjustment of investor equities is fair and impartial.
• The members of the same class are treated fairly and
equally.

If the reorganisation plan is approved, the secured creditors
are prohibited from enforcing their security interests during the
restructuring.
The court can terminate a reorganisation plan if the debtor is unable or fails to implement the reorganisation plan (Article 93, Bankruptcy Law). If the court orders a liquidation, the creditors are no longer bound by any promises to adjust their debts as part of the restructuring.

Conciliation
Rather than restructure or liquidate, Chinese law permits an insolvent company to negotiate a settlement (called conciliation) with its creditors. Conciliation must be approved by the court and by a majority of creditors that represent two-thirds of the total unsecured debt (Article 97, Bankruptcy Law). After the court orders conciliation, secured creditors can enforce their rights (Article 96, Bankruptcy Law). If the court later terminates an approved settlement because of fraud or other wrongdoing, payments made to the creditors under the conciliation remain valid to the extent that other creditors receive the same discharge ratio. Any surplus will be recaptured (Article 103, Bankruptcy Law). If the settlement is terminated because the debtor is unable or fails to implement the settlement, payments made to the creditors under the conciliation remain valid, unpaid amounts are treated as debts in the liquidation, and the creditors are no longer bound by any promises to adjust their debts as part of the conciliation (Articles 103-104, Bankruptcy Law).

Enforcement of foreign judgments
Chinese bankruptcy law recognises foreign orders and judgments including those issued or rendered by a US court based on international convention or the principle of comity, subject to three conditions (Article 5, Bankruptcy Law):

- The general principles of Chinese law are not violated.
- China’s sovereignty, security, and social and public interest are not impaired.
- The legitimate rights of Chinese creditors are not impaired.

There is little guidance and public information as to what standards the courts will apply to assess these criteria in bankruptcy cases.

Comparison with the US
In summary, Chinese bankruptcy law has the following key similarities with, and differences from, the US Chapter 11 proceeding:

- **Automatic stay.** Under the US Chapter 11, an automatic stay is imposed on filing, although relief from the stay is possible by a motion to the court. In contrast, the scope of the stay in China is more limited.

- **Rejection of executory contracts.** Under Chapter 11, a trustee can assume or reject an executory contract at any time before the confirmation of a plan. In contrast, an administrator in China must assume or reject an executory contract within two months of the court’s acceptance of a petition or within 30 days after the request of a decision by the counterparty.

- **Debtor’s management.** Under Chapter 11, a debtor remains in possession and continues to operate the business and maintain control of its assets, unless a trustee is appointed for cause. In China, the court appoints an administrator on acceptance of a petition and the administrator is usually active in reorganisation until the reorganisation plan is implemented.

- **Voidable transfers.** Similar to the US scheme, an administrator in China has avoidance powers to recover assets transferred during certain specified time periods before the bankruptcy.

- **Enforcement of foreign awards.** Chapter 15 of the US Bankruptcy Code incorporates the Model Law on Cross Border Insolvency by the UN Commission on International Trade Law. The Chinese bankruptcy code recognises foreign orders and judgments based on the principle of comity or international convention, subject to the relevant criteria (see above).

- **Proof of claims.** Under Chapter 11, the debtor files schedules of debts with the court. Only those creditors whose debts are not listed, or listed but disputed, contingent or unliquidated, are required to file a proof of claim before the bar date. In China, all creditors must declare any debt owed (except employee-related claims) within a time frame set by the court. A written explanation of the claims and supporting evidence must be provided.

Finally, although there are many similarities between the insolvency frameworks in the three countries discussed in this article, there are significant differences of both principle and practice that should be taken into consideration when assessing outsourcing-related risks and options. Nevertheless, there are a number of basic steps that outsourcing customers can take to protect their interests. These include:

- Negotiating termination rights based on pre-bankruptcy triggering events.
- Paying particular attention to the potential severability of contract elements.
- Carefully defining the customer’s rights to IP and operational materials in the event of a supplier’s bankruptcy.
- Arranging escrows of essential materials.
- Negotiating waivers of any non-solicitation and other “no hire” provisions that would impede the customer’s ability to establish alternative service arrangements.

Careful attention to these issues will put customers in the best position to navigate the complexities of local insolvency laws.

*The authors would like to thank Jonathan Butler (San Francisco), Leo Crowley (New York), Erica Carrig (New York) and Li Jun and Qiaozhu Chen (Shanghai) for their contribution to this article. Pillsbury Winthrop Pittman LLP does not practice law in India.*
CONTRIBUTOR DETAILS

MICHAEL MURPHY
Pillsbury Winthrop Shaw Pittman LLP
T +1 415 983 1303
F +1 415 983 1200
E michael.murphy@pillsburylaw.com
W www.pillsburylaw.com

JOSHUA KONVISSER
Pillsbury Winthrop Shaw Pittman LLP
T +1 212 858 1027
F +1 212 858 1500
E joshua.konvisser@pillsburylaw.com
W www.pillsburylaw.com

YUSUF SAFDARI
Pillsbury Winthrop Shaw Pittman LLP
T +1 650 233 4672
F +1 650 233 4545
E yusuf.safdari@pillsburylaw.com
W www.pillsburylaw.com