

# EXITING CHINA: PROCEDURES TO ENSURE THE ORDERLY LIQUIDATION OF A BUSINESS

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## I. INTRODUCTION

The global financial crisis has affected nearly all businesses

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in all industries in all markets. Weaker companies are floundering and failing, while stronger companies are reevaluating their business models and operations worldwide. The situation has led companies to reduce their payrolls, sell non-strategic assets, eliminate unnecessary business units and liquidate foreign operations.<sup>1</sup> Even the booming economy in China may no longer be a prize worth pursuing in this difficult economic environment.<sup>2</sup> This Article focuses on the procedures for and effects of liquidating a business in China and addresses relevant strategies for undertaking an orderly exit. Although the immediate context is China, many of the strategies discussed may be applied to any foreign market.

## II. EXIT PLANS

When liquidating foreign operations, most businesses hope to spend as little money and resources as necessary because they are “done” with their business in that particular country. It is important, however, to liquidate properly and adhere to a well-developed exit plan. Particular attention must be given to unique laws governing liquidation (or gaps in such laws that fail to specify how liquidation may occur).<sup>3</sup>

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1. See Dezan Shira & Associates, *Closing Down Representative Offices and Liquidating Businesses in China*, CHINA BRIEFING, Jan. 2010, at 3–11 (explaining the best methods to go about closing offices and liquidating assets in the current global financial crisis), available at [http://www.mrg-sroc.com/Files/Docs/PT\\_21748\\_CB201002Spec.pdf](http://www.mrg-sroc.com/Files/Docs/PT_21748_CB201002Spec.pdf); see generally Cyril V. Jones, *Rekindling the Flame: How the Coming Fundamental Changes in U.S. Financial Markets Due to the Global Financial Crisis Could Improve Foreign Direct Investment in the United States*, 32 HOUS. J. INT'L L. 245, 257 (2009) (citing Thomas Friedman, *Gonna Need a Bigger Boat*, N.Y. TIMES, Nov. 16, 2008, at WK12) (explaining how the housing crisis became a credit crisis, which turned into a financial crisis, and ended up as a global economic crisis affecting varying types of businesses).

2. Kathleen Cao, *Winding Up Your Business in China*, R & P CHINA LAWYERS (Feb. 20, 2011), [http://www.rplawyers.com/lwfbxqe.asp?id=75&lm\\_id=5](http://www.rplawyers.com/lwfbxqe.asp?id=75&lm_id=5).

3. For example, some relevant laws in Latin American countries are:

- Colombia Commercial Code art. 218–24, 469–97;
- Guatemala Commercial Code art. 213–21;
- El Salvador Commercial Code art. 358–62;
- Mexico General Law of Mercantile Companies art. 229–49;
- Nicaragua Commercial Code art. 337–40; and,
- Peru General Companies Law art. 402, 404.

An appropriate exit plan will help any business enterprise by strategizing how best to avoid financial penalties and fines but still recover maximum returns on assets abroad. Failure to liquidate properly in many countries can result in the imposition of taxes and fines that encumber all assets in the particular country.<sup>4</sup> These fines may affect an affiliated or related business enterprise, minimizing the gains made through liquidation. Moreover, businesses typically have paid taxes or made deposits to foreign governmental entities that may be recovered if liquidation is completed properly.<sup>5</sup> Careful planning can also help preserve the opportunity to resume operations in the future or otherwise do business again in the country, which will remain important for investors, if not for the business itself. Most importantly, a good plan will help the company and its officers avoid criminal liability under local law. Many countries impose criminal liability on designated local and foreign representatives of a business.<sup>6</sup> In China, if certain liabilities are not properly addressed, such as statutory severance payments for employees, local and foreign representatives may be criminally liable.<sup>7</sup>

A viable plan will consider: relevant law; administrative procedures; local, regional and national governmental filings; existing contractual and financial obligations; local assets; affected employees; bank accounts; judicial proceedings; and

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4. See generally *supra* note 3 and accompanying text; see also *Company Liquidation Procedures under Korean Law*, SIGONG LAW, P.C., [http://www.korealaw.com/sub/information/boardView.asp?brdId=corporate&brdIdx=104&gotopage=1&search=&search\\_string=](http://www.korealaw.com/sub/information/boardView.asp?brdId=corporate&brdIdx=104&gotopage=1&search=&search_string=) (last visited June 21, 2011) (detailing the procedures required for liquidation under Korean law).

5. Dezan Shira & Associates, *supra* note 1, at 5, 7.

6. DIGEST OF COMMERCIAL LAWS OF THE WORLD, MEXICO: DIGEST, 93 (Stephan Kinsella et al. eds., Vol. 3, 2008).

7. Audrey Chen, *Doing Business in China*, PLC CROSS-BORDER DOING BUSINESS IN . . . HANDBOOK (Oct. 2010), available at [http://crossborder.practicallaw.com/8-501-1377?q=\\* &qp=&qo= &qe=](http://crossborder.practicallaw.com/8-501-1377?q=* &qp=&qo= &qe=); see also Virginia Ho, *From Contracts to Compliance? An Early Look at Implementation under China's New Labor Legislation*, 23 Colum. J. ASIAN L. 35, 38–39 (2009) (citing the Zhonghua Renmin Gongheguo Laodong Hetong Fa [The PRC Labour Contract Law] (promulgated by the Standing Comm. Nat'l People's Cong., June 29, 2007, effective January 1, 2008), available at [http://www.molss.gov.cn/gb/news/2000706/30/content\\_184630.htm](http://www.molss.gov.cn/gb/news/2000706/30/content_184630.htm) (providing possible criminal liability for failing to satisfy the Chinese statutory requirements)).

related issues. The exit plan should lay out the time for execution, necessary actions and persons required to carry out the actions, and any risks (such as potential delays) that may impact an important aspect of the plan.<sup>8</sup>

Given the complexity of opening a business and operating it successfully in most Asian markets, as well as the expectations that accompany any investment in the Chinese market, it is not surprising that these concerns are particularly relevant when one is liquidating a business in China. Thus, a good plan is vital to successful liquidation in the Chinese market.

### III. RECENT DEVELOPMENTS IN CHINA PERTAINING TO VOLUNTARY LIQUIDATION

At the 1447th meeting of the Judicial Committee of the Supreme People's Court on May 5, 2008, the Provisions of the Supreme People's Court on Some Issues about the Application of the Company Law of the People's Republic of China (II) (Liquidation Provisions) were adopted.<sup>9</sup> The Liquidation Provisions provide a framework for dissolution and liquidation of Chinese enterprises and foreign-invested enterprises while also increasing creditors' and shareholders' rights.<sup>10</sup> The Liquidation Provisions apply to a company that needs to liquidate but does not necessarily need bankruptcy relief.<sup>11</sup>

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8. It is important to consider that often the implementation of a law may differ from its formal reading, leading to delays that even local counsel may not be able to anticipate. It is often helpful to review the experience of other companies ceasing operations when developing the plan.

9. See Provisions of the Supreme People's Court on Some Issues About the Application of Company Law of the People's Republic of China (II) (promulgated by the Judicial Comm. of the Supreme People's Court, May 5, 2008, effective May 19, 2008) 2008 FA SHI 6, translated by Ministry of Commerce of the People's Republic of China, available at [http://www.fdi.gov.cn/pub/FDI\\_EN/Laws/GeneralLawsandRegulations/JudicialInterpretation/P020080722549411097019.pdf](http://www.fdi.gov.cn/pub/FDI_EN/Laws/GeneralLawsandRegulations/JudicialInterpretation/P020080722549411097019.pdf) [hereinafter Liquidation Provisions].

10. See *id.*

11. *Id.* China established its own business bankruptcy law that became effective June 1, 2007. Zhonghua Renmin Gongheguo qi ye po chan fa [Enterprise Bankruptcy Law of the People's Republic of China] (promulgated by Standing Comm. Nat'l People's Cong., Aug. 27, 2006, effective Jun. 1, 2007), available at [http://www.gov.cn/ziliao/flfg/2006-08/28/content\\_371296.htm](http://www.gov.cn/ziliao/flfg/2006-08/28/content_371296.htm), translated at <http://www.lehmanlaw.com/resource-centre/laws-and-regulations/company/the-enterprise-bankruptcy-law-of-the-peoples->

Prior to the enactment of the Liquidation Provisions, enterprises could have their finances depleted in China with little effective recourse for creditors or shareholders.<sup>12</sup> The Liquidation Provisions now provide a structure and incentive for an orderly liquidation. These changes are particularly important for foreign investors in China.

Smaller U.S. investors, in particular, often enter the Chinese market through joint ventures or minority equity investments in existing Chinese businesses.<sup>13</sup> In both situations, the Chinese business partners may remain in control and may refuse to address declining revenues, increasing expenses, or failed business models. The problem is particularly acute when the Chinese business partner has not accurately reported the financial position of the company to the U.S. investors. The Liquidation Provisions will allow U.S. investors faced with these circumstances to seek an orderly liquidation.

As a preliminary matter, the Liquidation Provisions allow minority shareholders to commence dissolution under certain circumstances.<sup>14</sup> Minority rights contained in the Liquidation

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republic-of-china.html.

12. See Faegre & Benson, *Provisions on Some Issues Regarding Application of the PRC Company Law*, CHINA LAW UPDATE, Aug. 2008, at 4–6 (comparing the prior Chinese law, *Measures for Liquidation of Foreign Invested Enterprises*, with the newly established Liquidation Provisions).

13. See generally Xun Wang & David A. Ralston, *Strategies for Small and Medium-Sized U.S. Business Interested in Investing in China: Lessons that Can Be Learned from Taiwanese Companies*, 42 THUNDERBIRD INT'L. BUS. REV. 677 (2000) (overview of the strategies used and role filled by small U.S. investors in the Chinese market).

14. See Liquidation Provisions, *supra* note 9, art. 1. The Liquidation Provisions translated therein provide:

Where any shareholders, separately or jointly, holding 10 percent or more of the shareholder's voting rights of a company file a lawsuit to dissolve the company with any of the following grounds and accord with provisions in Article 183 of the Company Law, the People's court shall accept the lawsuit:

(1) The company cannot hold the meeting of shareholders or the general meeting of shareholders for two or more consecutive years, and the company has serious difficulties in its operation and management;

(2) Valid resolutions cannot be made in the meeting of shareholders or the general meeting of shareholders for two or more consecutive years due to the voting by shareholders cannot reach the statutory proportion or the proportion provided in the articles of association of the company, and the

Provisions generally serve as motivation for controlling shareholders and directors to either properly manage a company that is still viable, or voluntarily dissolve a company that is no longer viable in an orderly fashion. The Liquidation Provisions also may provide relief to a U.S. investor that holds a minority interest in a troubled business in China and is concerned that the Chinese partners are not taking steps to resolve the situation.

When a company voluntarily dissolves in China, it must set up a “liquidation group” within 15 days after dissolution.<sup>15</sup> The liquidation group is a committee that can consist of shareholders, creditors, officers, directors, senior management, and professionals.<sup>16</sup> If a liquidation group is established but the liquidation is delayed intentionally, creditors or shareholders can apply to the court to establish a new liquidation group.<sup>17</sup>

The liquidation group is responsible for developing a liquidation plan.<sup>18</sup> These plans are proposed either to the shareholders (in a voluntary liquidation), or the court (in an involuntary liquidation).<sup>19</sup> When there are insufficient assets to pay creditors fully and the liquidation committee is unable to reach a consensual repayment plan with creditors, the company

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company has serious difficulties in its operation and management;

(3) The directors of the company are in conflict for a long time, which cannot be solved through the meeting of shareholders or the general meeting of shareholders, and the company has serious difficulties in its operation and management;

(4) The company has any other kinds of serious difficulties in its operation and management and its continuous existence may cause major damage to the interests of shareholders.

Where any shareholders file a lawsuit to dissolve the company on grounds that their rights and interests such as the right to information, the claim for profit distribution are damaged, or the company is in deficit and its properties are insufficient to pay off all debts, or the business license of enterprise legal person of the company has been revoked but the liquidation has not been conducted yet, the people’s court shall not accept the lawsuit.

*Id.* art. 1.

15. *Id.* art. 7.

16. *Id.* art. 8.

17. *Id.* art. 7.

18. *Id.* art. 15.

19. *Id.* art. 15.

must then announce bankruptcy under applicable law.<sup>20</sup> In China, bankruptcy generally results in a lesser distribution among creditors,<sup>21</sup> thus incentivizing creditors to reach a consensual repayment plan with the liquidation group.

Controlling shareholders and directors can be held personally liable to the extent they fail to timely establish a liquidation group or cause the loss of records, delaying liquidation.<sup>22</sup> The prospect of personal liability may be sufficient to pressure management to act when it would otherwise fail to respond to the concerns of minority investors.

The Liquidation Provisions try to balance the competing objectives of preserving viable businesses while protecting creditors' rights. Encouraging early, but orderly, reorganization or liquidation remains the principal goal. To that end, a foreign investor in China should weave together an understanding of the Liquidation Provisions with a practical approach to the liquidation, regardless of whether the liquidation is due to looming insolvency or simply to a desire to exit China to pursue other business opportunities.

#### IV. CREATING A LIQUIDATION TEAM FOR A VOLUNTARY LIQUIDATION

The first practical step to an orderly and proper exit is developing a team to implement and execute an exit plan. The appropriate team size will depend on the complexity of the business. In general, the team should consist of key managers in accounting, human resources, finance, information technology, records, legal, and operations. Due regard must be given to including Chinese members on the team, in order to identify and

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20. *Id.* art. 17.

21. See generally Cai Xuejue, *A Comparative Study between some different features of China and Australia Insolvency System*, INTERNATIONAL LEGAL SERVICES ADVISORY COUNCIL, available at [http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/InternationalLegalCooperation\\_Australia-China](http://www.ilsac.gov.au/www/ilsac/ilsac.nsf/Page/InternationalLegalCooperation_Australia-China) LegalProfessionDevelopmentProgram\_ACLPDPProgram2009\_ACLPDPProgram2009 (comparing and contrasting the rights of creditors in China to those of Western legal systems, concluding that creditors have more rights and are entitled to greater distribution in Western legal systems than in China).

22. Liquidation Provisions, *supra* note 9, art. 18–21.

address cultural norms. The core team in turn should retain appropriate professionals, both inside and outside China, to assist in carrying out their duties. Local professionals, including lawyers and accountants, are particularly important team members for a Chinese liquidation team. They will ensure that all government permits, licenses and tax filings are properly addressed.

## V. GATHERING INFORMATION

Before establishing an exit plan, the team needs to identify key information. First, the team should review areas of concern for the business.<sup>23</sup> Any looming issues should be identified early so they can be addressed appropriately before growing into larger issues. Second, a list of assets, including inventory, accounts, bonds, insurance, and deposits, should be created. This asset list will make execution of the plan more efficient as the team proceeds to liquidate the foreign operations. Third, the liquidation team should develop a list of liabilities or obligations. A key consideration will be whether the company will be permitted to liquidate if it cannot satisfy all those liabilities. In China, particular attention should be given to whether there are “inchoate” or hidden liabilities created by the Chinese investors or partners. Chinese companies often maintain a second set of books that may contain liabilities not reflected on the company’s official balance sheet.<sup>24</sup>

## VI. DEVELOPING A DETAILED EXIT PLAN

After the team has gathered the necessary information, it should develop a detailed plan. The plan should consider and outline deadlines for required notifications, such as tax or labor related notices. The plan should include a process for resolving

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23. For example, are creditors demanding payment? What is the status of the company’s bank accounts? Will key customers have access to alternative suppliers or can they be supplied through a related business? Which key employees must be retained throughout the liquidation process? How long will a Chinese physical address be required?

24. Dexter Roberts et al., *Secrets, Lies, and Sweat Shops*, BUSINESSWEEK, Nov. 27, 2006, available at [http://www.businessweek.com/magazine/content/06\\_48/b4011001.htm](http://www.businessweek.com/magazine/content/06_48/b4011001.htm).

each set of issues the team identified, including disposition of assets, filing final tax returns and severing employment relationships. The plan should include a schedule for implementing each step and the members of the team responsible for completing each step. The following steps in particular must not be overlooked:

- i. terminating or transferring contractual obligations;
- ii. severing employment relationships;
- iii. disposing of or transferring remaining assets;
- iv. settling accounts payable and debt obligations;
- v. filing formal dissolution documents;
- vi. filing required tax returns;
- vii. closing local bank accounts;
- viii. preserving (or disposing of) records; and
- ix. determining how any offshore holding companies will be affected

Finally, the plan should include a schedule for meetings with local (and, if appropriate, regional or national) government officials to preserve relationships and ensure there are no lingering liabilities after the company ceases to exist.

## VII. EXECUTING THE PLAN

With a team and a plan in place, execution should be straightforward. However, when dealing with a highly bureaucratic country (like China),<sup>25</sup> it will be important to continue refining the plan as well as managing expectations regarding timing as the process unfolds. One should expect to face unanticipated delays. For example, it is common for a local government or military official to decide that his or her agency must approve some aspect of the plan, creating potentially problematic delays.<sup>26</sup> Consequently, a key component in executing the plan smoothly is to ensure that the local members

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25. Joel B. Eisen, *China's Renewable Energy Law: A Platform for Green Leadership*, 35 WM. & MARY ENVTL. L & POL'Y REV. 1, 4 (2010).

26. Martin J. Weinstein, *The World of International Compliance: What Transactional Lawyers Need to Know to Perform Ethically and Responsibly*, 29 HOUS. J. INT'L L. 311, 318 (2007).

of the team maintain good relations with appropriate governmental authorities. These relationships can be fostered by effective communication of the exit plan, together with the foreign investor's intention to comply with all applicable laws.

#### VIII. CONCLUSION

Notwithstanding the unique circumstances faced by companies that exit China, a proper strategy and plan will improve the winding down and liquidation process. More importantly, a business that winds down properly will maximize enterprise value and preserve resources. When combined with an understanding of procedures required by local law, a company can exit China or any other country successfully.