



Restructuring an Underperforming Company in China:
Case Study

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Restructuring an underperforming business can be a challenging process, often either a transformation or a turnaround will need to be implemented. To show the process of business reconstruction and any possible fallout or effects, Company ABC will be used as an example.

Keep in mind that it is actually not possible to arrange an orderly liquidation. Company ABC has two options which are whether to file for 'Voluntary Bankruptcy' or 'Involuntary Bankruptcy'. It is preferable to use voluntary because the firm has more control over the process in terms of selling off their assets and working with the court appointed agents. However for this option the firm needs to be able to prove that they are balance sheet insolvent. If the firm cannot use voluntary bankruptcy then they must conduct involuntary. This is where the creditors will bring it under through legal cases against and will file an application for bankruptcy. In this scenario a firm has less control over the process and is subject to more scrutiny. The firm has limited control over the sale value of assets. Additionally creditors work with the court agents and can become aware of any wrongdoings. This is generally less safe for officers of the business.

Case Study: Company ABC

Company ABC is a family owned business of several generations, supplying retail outlets in the US. The business has a seasonal business demand with high production at some periods of the year and low production in other periods of the year. They have invested USD \$10 million in cash, equipment, rents, land and buildings. Company ABC employs full time and short term labour contract staff, for the full year activities and seasonal work respectively.

Usually the retailers will demand credit terms with Company ABC and Company ABC in turn has credit turns with their suppliers. Credit terms are set out so that seasonal orders and first collections allow for payment to creditors at end of their credit terms. In the low season Company ABC starts producing for the peak season. They need lines of credit to finance the pre-production. One should bear in mind that the retailers then have get out clauses to reduce or cancel orders in the high season if the goods have not sold. Because of the seasonal nature of the business, Company ABC cannot afford for manufacturing to be compromised especially during the peak period. If the manufacturing was compromised then this would disrupt their ability to generate sales during their busiest period. This could be compromised by pressure on their bank or equipment stemming from limited cash flow. At this time they are concerned that a bank in the US might not renew their credit line which would squeeze their cash reserves in China. Due to poor business position in terms of sales, credit terms and manufacturing, Company ABC cannot afford to have any sort of stresses on their bank or equipment.

Other considerations are that the raw materials have reduced in price putting pressure on suppliers which in turn put pressure on Company ABC. Taking this into account, Company ABC will either have a year of profitable financial performance if they are able to capitalise on low raw material costs, or a highly challenging year if financial performance should their debtors choose to reduce or cancel their orders. Company ABC has therefore sought to restructure their business to try and avoid collapse under these risky circumstances. The idea of restructuring is to reduce costs where possible, usually focused around headcount, but in Company ABC also in renegotiating credit terms. There are several stages to restructuring a business, which will be outlined utilising Company ABC as an example case study in practice.

Step 1 – Setting Up a New Entity

The overseas Head Office sets up a new holding company (called “Owner Company”) for China stock. Then there will be the establishment of a new manufacturing company (called “Manufacturing Company”) under the new holding company. The Owner Company will then invest into the Manufacturing Company sufficient capital to purchase assets of the old company as well as working capital. The Manufacturing Company will then buy the assets at fair market value, but the payment will not yet be made and kept as receivable/payable. The Manufacturing Company will next go through the process of hiring the employees they wish to retain from the old company. Company ABC will then outsource the manufacturing contracts to the Manufacturing Company who will complete the contract. Additionally all new contracts will go directly to the Manufacturing Company. Finally there would be a review of any IP remaining and transfer (purchase) what is beneficial to the Manufacturing Company or Owner Company as appropriate.

When preparing for the liquidation or deregistration process, there needs to be a review of the accounting records. Management will want to identify and minimise any potential risks arising from any non-compliance. This is including but not limited to accounting and taxation. Keep in mind that late payment interest or tax penalties are likely to arise from any non-compliance with tax laws or regulations, further expenses that the company cannot afford. It may be necessary to develop strategies to handle any issues that arise. Management might try to delay closure or try to keep activities dormant, until there are more favourable circumstances.

Step 2 – Cutting Costs through Downsizing

Following the establishment of their Manufacturing Company, Company ABC will slowly downsize by keeping the employees that the Manufacturing Company does not require. Management will likely want to transfer key staff to the new Manufacturing Company, however under Chinese Labour Law, if more than 20 persons or 10% of the workforce are being terminated then there is a need to make a formal announcement to staff and apply to the Labour Bureau. If the workers choose to resign then this is more lenient, so management could provide compensation and references as incentives. Company ABC should follow the ‘Last in First out’ rule for terminating employees, however if the firm recovers their financial position, management may choose to reverse it and adopt the ‘First out First in’ principle. This is fundamentally about treating the company’s employees fairly and trying to minimise any negative fallout from the downsizing procedure.

In addition to cutting labour costs, management can attempt to restructure their debts with creditors. This especially applies for the supply to the new company otherwise there may be a repeat of the current situation due to poor credit terms.

Step 3 – Cash Management Controls

The Manufacturing Company will now hold an informal creditor meeting with some (or all) of the creditors. The purpose of the meeting will be to discuss a discount on the historic debt, to make it manageable for repayment. The company could attempt to push the percentage of debt below the line in terms of repayment schedule and interest bearing. It may be necessary to remind creditors that it is better, for all parties to act together or in other words for the Manufacturing Company to remain trading. If one party is indecisive and inconsistent in its actions, the company will fail and the creditor’s recovery of debts may be significantly reduced. Planning would be useful and management should try to get major creditors on board first, as that action will help convince small creditors to stay in line.

Pointers for Staff Reduction

This can be the most important and challenging aspect in terms of implementation. It is advisable to have a list detailing who might cause difficulty and outline a plan to manage any issues. The whole goal of this restructuring process (apart from keeping the business operational) is to minimise business disruptions, so remember that disgruntled employees can cause significant disturbance. Management handling the staff reduction will need to be prepared to listen, a conversation about this will not be quick, but it is necessary for a successful restructuring.

Some strategies if particular individuals prove difficult are to;

- Give the employee 24 hours to think about the situation presented,
- Stay positive in the messaging conveyed to staff.
- Bring in outside help to deal with the issues at hand or explain to the employee the business difficulties.
- Know the labour law; having a comprehensive study of both an employer's and the employee's rights.

What Not To Do

If the company's plans do not come into fruition and creditors subsequently refuse to come to the table to agree to a plan, then Bankruptcy will likely occur in this event. However, the company can still apply to the courts to approve a plan for reorganisation of the debts. However this application is rarely approved so bankruptcy may be the only remaining option available.

Remember that during bankruptcy it is important to keep the firm at arm's length from the parent company, because then it is less likely to be investigated by the courts. Should there be a formal investigation, then the company must ensure that all the books are clean. This is because during a bankruptcy or liquidation procedure, all previous practices are brought to the surface and exposed.

Any underpayment of welfare, improper tax, VAT or customs filings all become visible. Therefore if the company files for Bankruptcy then they need to get their accounting records repackaged appropriately.

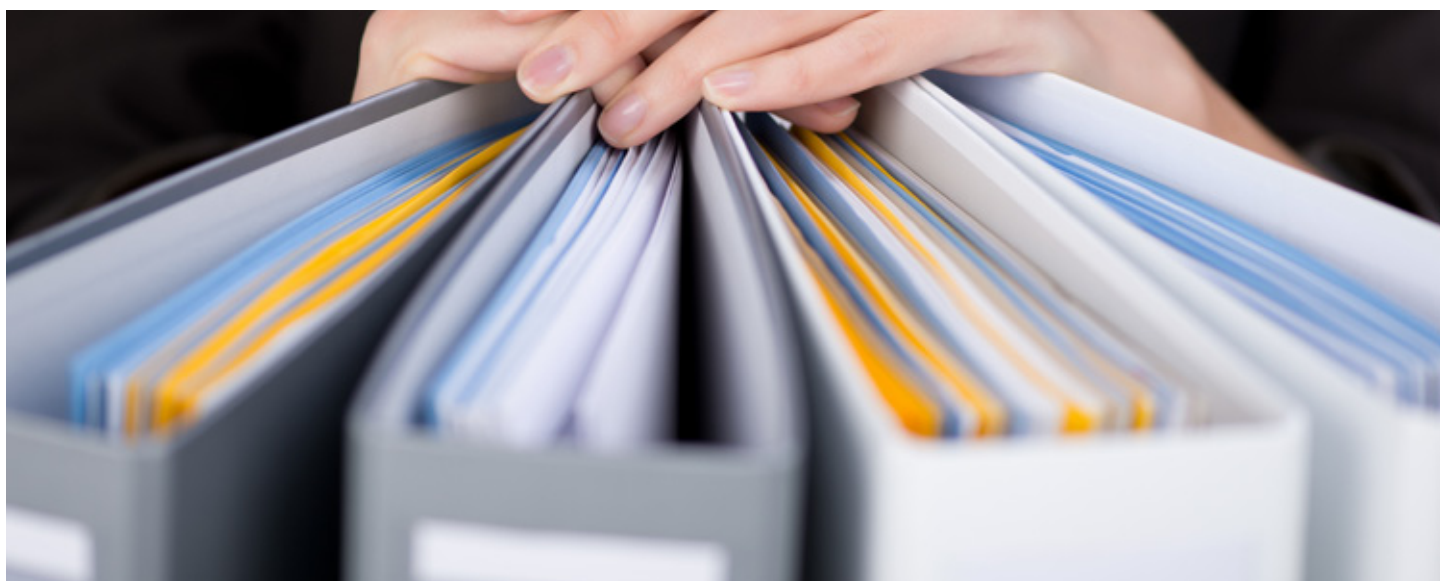
In terms of actual company restructuring what can be the most time consuming aspect and most difficult part of closing a business is the tax compliance procedure. The assessment will typically analyse three years of financial statements, for which the tax bureau can actually go back 10 years if they suspect fraudulent activity to have taken place.

WORST Case Scenario

Another company in a position similar to ABC failed to take action, resulting in the following scenario:

The creditors put liens on the company's assets, upon which their landlord learnt of the action and forcibly (illegally) closed the factory to which the local police turned a blind eye. It was lucky that the chops and accounting records had been already retained offsite by an appointed chop custodian. However, following the forced closure, the company's staff demonstrated outside the factory and this led to some civil unrest in the area. Consequently, the company's General Manager was placed under house arrest with their passport seized for over a year.

After a period of time, the local government got involved and paid severance packages, as the unrest spilled over into other economic areas. However the company eventually went bankrupt and the Company Headquarters later negotiated with the government for the release of their General Manager. Creditors also sought a class action against the Overseas Headquarters for owed debt in arrears. In the fallout from this, the company was unable to keep up capacity losing customers, property, as well as having their global sales negatively affected. This all might have been avoided had the company chosen to act decisively when necessary as opposed to delaying action.



About Us

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Combining years of international expertise with practical Chinese experience and knowledge, LehmanBrown offers expert advice and support to both local and international clients. Within the mid - tier, we are regarded as a market leader and our clients enjoy access to a combination of senior and experienced counsellors from both China and abroad.

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Professional Services

Audit & Assurance

External Audit

China Statutory Audit

US GAAP Audit

IFRS Audit

Hong Kong Statutory Audit

Internal Audit

Fraud Investigation

Forensic Accounting

Special Purpose Audit

Foreign Currency Audit

Royalty Audit

Capital Verification Audit

Valuation Services

Corporate Valuation

Damage Assessment Valuation

Intellectual Property Valuation

Asset Valuation

Special Purposes Valuation

Corporate Finance

Debt Restructuring

Acquisition, Disposal & Financing

Mergers & Acquisitions

Transaction Advisory

M&A Divesture

M&A Integration

Financial Due Diligence

Business Services

Company Registration & Maintenance

Market Entry Advisory

Updating Company Certificates

Annual Inspection & Reporting

Company Secretarial Services

Company Ownership Transferring/Corporate Restructuring

Background/Credit Checking

Company Deregistration & Bankruptcy

HR Support Services

China Visa Services for Expatriates

Social Welfare Structures

Outsourcing Services

Accounting & Bookkeeping

Budgeting & Forecasting

Financial Statement Preparation

Head Office Reporting

Financial Management

Interim Financial Management

Finance Manager Function

CFO Function

Cash Flow Management

Treasury Management

Set-up of Bank Account

Payroll Services

Payroll Processing Setup

Expatriate Employees

Local Employees

Secondment & Temping Service

Chop Custodian Services

Taxation Services

Individual Tax Planning (IIT)

Tax Immigration & Investment Review

US & Overseas Personal Income Tax Planning & Filing

IIT Tax Payment Facilitation

Application for Individual Income Tax Refund

Expatriate Staff Individual Income Tax Staff Filing

Local Staff Individual Income Tax

Company Taxation (CIT)

Tax Consulting

Corporate Tax Planning

Business Restructuring

Value Chain Review

Onshore / Offshore Investment

Transfer Pricing

Tax Compliance

Tax Due Diligence

Tax Deregistration

Negotiation of Tax Penalties

Tax Refund Application

Tax Representatives for Tax Audit

VAT & Customs Duty Clearance

PRC Tax Receipt Verification

VAT Application

VAT & Sales Tax Filing

Corporate Income Tax Reporting

Specialist Accounting & Risk Management

Internal Controls

Systems

Risk Management

Sarbanes - Oxley (SOX 404)

GAAP, SEC & IFRS Compliance

US GAAP

US GAAP Financial Statement Preparation

US GAAP Conversion

Other GAAP

GAAP Conversion

Public Company Compliance

Financial Statement Preparation

IFRS

IFRS Accounting Repackaging

IFRS Financial Statement Preparation

IFRS Public Company Compliance

SEC

SEC Public Company Compliance

Legal Services

Legal Advisory

Labour Legal Advisory

Workforce Downsizing Advisory

Labour Tribunal Assistance & Advisory

Labour Law Review & Audits

Review & Preparation of Employment Contracts

Corporate Legal Advisory

Legal Due Diligence

Corporate Restructuring Advisory

Review & Preparation of Articles of Association (AoA)

Review & Preparation of JV Contracts

Review & Preparation of Repatriation Agreements

Other Legal Services

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Debt Collection Assistance

Litigation Support

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For further information about how we can add value and support your individual or business needs, please contact us.

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