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How the New PRC Enterprise Bankruptcy Law has Fared – Restructuring of A-share Listed Companies and Cross-border Implications

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Contents

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Acknowledgement

INSOL is delighted to present this excellent paper titled “How the New PRC Enterprise Bankruptcy Law has Fared – Restructuring of A-share Listed Companies and Cross-border Implications” written by Alan C W Tang, Partner and Head of Specialist Advisory Services, Grant Thornton, Hong Kong and China.

This paper is very timely, as there appears to be a new approach that is developing in the PRC where the Stock Exchanges are considering opening up their doors to foreign companies to be listed in the PRC. Overseas investors and insolvent practitioners would therefore be interested to know what would happen to listed companies in the PRC in the event they face financial difficulties.

The first part of this paper examines how the new PRC Enterprise Bankruptcy Law has affected these distressed listed companies. In the later part of this paper, there is a brief reflection on the bankruptcy of non-listed companies under the New Law. Background to cross-border aspects of the New Law is also given.

INSOL would like to thank Alan Tang for taking the time to write this excellent paper at a time when Insolvency practitioners are extremely busy, and we appreciate the time he has devoted to writing this paper.

How the New PRC Enterprise Bankruptcy Law has Fared – Reorganisation of A-share Listed Companies and Cross-border implications

By: Alan CW Tang
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Introduction

With recent reports in April/May 2009 that the PRC Stock Exchanges are considering opening up their doors to foreign companies to be listed in the PRC, overseas investors and insolvency practitioners would be interested to know what would happen to listed companies in the PRC when they faced financial difficulties. The first part of this article examines how the new PRC Enterprise Bankruptcy Law ("New Law" - promulgated on 27 August 2006 and effective 1 June 2007) has affected these distressed listed companies. In a later part of this article, there will be a brief reflection on the bankruptcy of non-listed companies under the New Law. Background to cross-border aspects of the New Law is also given.

Grant Thornton recently conducted a survey in the PRC based on public information including announcements made by the "ST"[1] companies with shares listed for trading in the Stock Exchanges of Shenzhen or Shanghai. The survey focused on listed company reorganisation under the New Law. As of 27 July 2009, there were 177 ST companies, about 9% in number of the total listed companies on the two PRC Stock Exchanges. Sixteen of these ST companies have undergone some form of reorganisation since June 2007 using the New Law.

Reorganisation of Listed Companies

Very few listed companies in the PRC have been allowed by the Government to go into bankruptcy; for those that have, there was often some element of fraud and malpractice by management (e.g. the Sanlu Milk scandal in 2008). The Government is concerned about the likely social impact when a listed company goes into bankruptcy, with tens of thousands of shareholders holding worthless paper and losing possibly their life-savings, not to mention the loss of jobs for the hundreds if not thousands of employees. Thus, psychologically, a listed company in the PRC is often regarded by local investors as infallible, it will not “close shop” unless it is necessary and even then often only with the political will and Government blessing.

ST companies are under severe pressure to restructure as they will lose their listing status otherwise[2]. There is a value for the listing status as such and listed companies are keen to preserve that status. Under the old Enterprise Bankruptcy Law (for trial implementation)[3] ("the Old Law"), which applied to State-owned Enterprises only, there was simply no avenue or legal basis for reorganisation of these listed companies (most of which are not directly State-owned any way). Under the provisions for reorganisation under the New Law[4], a company or its creditors are eligible to apply to the court for reorganisation whenever the company is insolvent and is unable to pay its debts when due[5].

Almost all of these listed company reorganisations are "pre-packs", with substantial local government (including court) support, influence if not outright direction. Invariably, one or more of the big commercial banks (principally State-owned) are their major creditors (and often with property mortgage or other security). In alignment with State policy, these banks are more than prepared to be guided by local government and the court in handling a reorganisation of listed companies of which they are major creditors.

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1 The Stock Exchanges and the China Securities Regulatory Commission ("**CSRC**") determine whether a listed company will be put under the "special treatment" status, by reference to, inter alia, various financial and operational related factors, such as the reporting of net losses for two consecutive financial years.
2 ST companies will normally lose their listing status after 3 years of becoming "ST".
3 Promulgated on 2 December 1986 and effective from 1 November 1988 as “on trial”.
4 The New Law applies to all business enterprises, including State-owned Enterprises and Foreign Investment Enterprises. Chapter 8 (Articles 70 to 94) contains the law for reorganisation – see Article 70.
5 See Article 2 of the Enterprise Bankruptcy Law – both the "balance sheet" and "cash flow" tests are used to determine "insolvency".

Survey

Table 1 summarises a survey on the 16 listed ST company reorganisations under the New Law

Stock Code	Stock Name (Note 1)	Location of court accepting the application for reorganisation	Date of application for reorganisation	Date of approval to commence process of reorganisation	Date of approval of reorganisation proposal
600722	*ST Canghua	Hebei	2007-6-12	2007-11-16	2007-12-24
000631	S*ST Lanbao	Jilin	2007-6-14	2007-11-16	2007-12-21
000670	S*ST Tianfa	Hubei	2007-7-1	2008-8-13	2007-10-11
600703	ST Sanan	Hubei	2007-8-1	2007-8-13	2007-11-3
000925	S*ST Haina	Zhejiang	2007-9-14	2007-9-26	2007-11-23
000688	S*ST Zhaohua	Chongqing	2007-11-6	2007-11-16	2007-12-24
000561	S*ST Changling	Shanxi	2007-11-22	2008-5-15	2008-11-6
000892	S*ST Xingmei	Chongqing	2007-12-17	2008-3-11	2008-4-22
600155	*ST Baoshuo	Hebei	2007-12-28	2008-1-3	2008-2-5
600705	S*ST Beiya	Heilongjiang	2008-1-28	2008-2-3	2008-4-24
600242	S*ST Hualong	Guangdong	2008-3-12	2008-4-17	2008-4-23
600094	*ST Huayuan	Shanghai	2008-8-11	2008-9-27	2008-12-27
600180	*ST Jiufa	Shandong	2008-9-16	2008-9-28	2008-12-9
200160	*ST DixianB	Hebei	2008-11-5	2008-11-10	2008-12-31
600556	*ST Beisheng	Guangxi	2008-11-27	2008-11-27	2008-12-30
000498	*ST Danhua	Liaoning	2009-5-12	2009-5-13	Note 2

Note 1: "ST" means reporting losses for two consecutive years, or with negative shareholders' equity; "*ST" means reporting loss for three consecutive years, with risks of being delisted; "S" as a prefix means previous "State-ownership" capital reorganisation programme not yet completed.

Note 2: Approval, if given, has not been announced.

It should be noted that the duration for the "reorganisation process" for ST listed company cases so far has always been less than one year.

Effective "Pre-packs"

Under the New Law, a six-month period[6] is allowed for a company to negotiate with creditors on terms of the reorganisation proposal. Except for three cases which took more than 150 days, none of the 16 ST companies took more than 100 days to compromise with their creditors and agree on the terms for the reorganisation proposal. In five cases, it took less than 2 months from application to completion of the reorganisation. ST Beisheng took only 33 days! With full support from the relevant Government departments, the courts and the regulatory authorities, these reorganisation packages were endorsed and put into effect virtually in no time. This is akin to the "pre-packs" one finds in similar processes in the US Chapter 11 and UK administration proceedings.

Liquidation Committee vs. Administrator

To meet the requirements for the office of administrators as provided for in the New Law[7], the relevant courts have set up registers of court approved panels of administrators[8]. Yet it is worth noting that the respective "administrators" for these listed company reorganisation cases were ordered to be formed by the courts without resorting to the system of appointment of court approved administrators through the "panel" system. All of these administrators take the form of "liquidation committees"[9] directly appointed by the courts concerned.

Each of these "administrators" (liquidation committees) usually comprises an approved court-registered administrator (an individual), a lawyer, a financial consultant, and representatives from the local government authorities such as Finance Bureau, Labour Bureau and the State-owned Assets Supervision and Administration Commission etc. This arrangement appears to revert to the "old" method of appointing a government dominated committee to administer the liquidation of State-owned enterprises under the Old Law.

Case Study

We now look at a case study in respect of Company A to highlight some common features of a reorganisation of ST listed companies.

A creditor of Company A filed a bankruptcy petition with the local Intermediate People's Court expressly for the purpose of reorganisation. On the following day, the local court referred the application to the provincial High Court for consideration. Nine days later, the High Court agreed to "accept" or register the application[10] and appointed an "administrator"[11]. The administrator took the form of a bankruptcy liquidation committee comprising three government officials, one lawyer and one accountant. The administrator took office and immediately commenced the process of seeking approval for reorganisation.

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6 See Article 79.

7 Chapter 3 (Articles 22 to 29) contains the law governing Administrators. The Supreme People's Court also issued, on 4 April 2007, Regulations Governing the Appointment of Administrators, as well as Regulations Governing the Remuneration of Administrators.

8 The latest estimates are that there are approximately 9,000 approved administrators on the court panels throughout the PRC.

9 Article 24 stipulates 5 approved sources of administrators: Government-appointed "liquidation committee", legal firms, accounting firms, bankruptcy and liquidation firms and qualified individuals.

10 The Court does not necessarily or always "accept" or register all bankruptcy petitions (or indeed any form of litigation in the PRC). Courts may and do decline to register cases brought before them. Article 10 requires the Court to either "accept" (or register) or "reject" (or decline to register) a petition within 15 to 30 days (depending on conditions as specified) of its original filing.

11 Article 13 provides that the Court should appoint an administrator at the time of "accepting" (or registering) a bankruptcy petition.

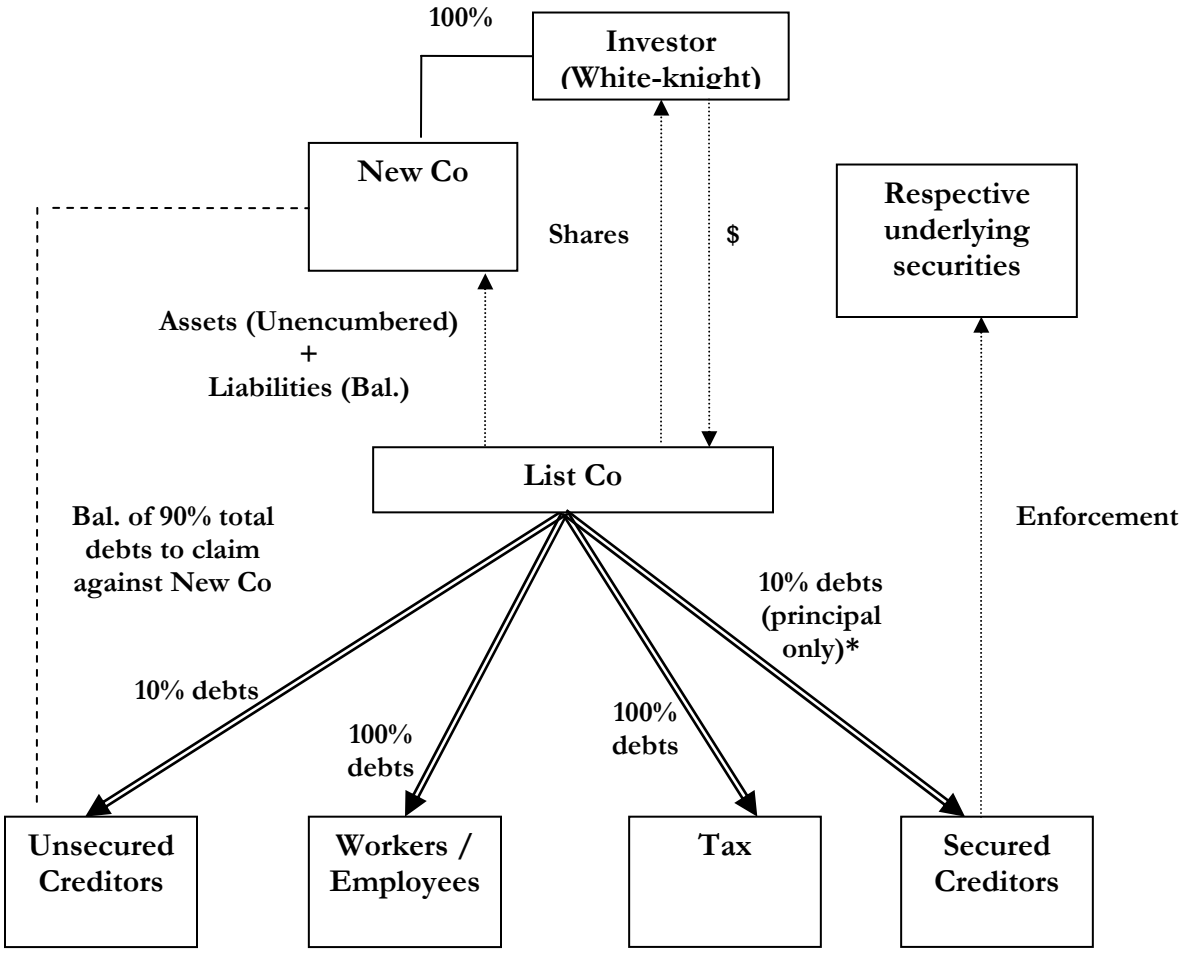
Chronology of salient events in the approval stage for the reorganisation is as follows:

Day 1[12]	Notice was sent to all known creditors to submit claims
Day 11	Liquidation committee formed and its members appointed
Day 35	Reorganisation scheme duly approved at the first meeting of creditors
Day 38	The local Intermediate People's Court sanctioned reorganisation scheme

Key operative and financial terms in respect of creditors under the reorganisation scheme are summarised below:

Type of creditor	***No of creditors***	***Total amount of claims (in RMB' million)***	***Repayment terms***
Secured	3	392	Deferred enforcement over respective securities, plus one-off payment of 10% principal debts as compensation
Employees	44	2	100% in full
Tax	1	7	100% in full
Unsecured	59	1,344	One-off payment of 10% principal, balance of 90% to be novated to Newco which acquired all unencumbered assets and remaining liabilities of Co A (see chart below)

[12] Article 14 provides that once a petition is "accepted" (or registered), the Court should notify all creditors within 25 days.



* In consideration of forbearance in delay in enforcing securities.

In essence, the investor injected cash to pay off parts of the existing debts of Company A, effectively in exchange for the "listing status" of Company A. New assets and businesses from the investor, which is now a major shareholder, are then injected into the revamped Company A.

In accounting terms, the waiver of its debts due to creditors would have generated substantial "book profit" to reduce the cumulative losses of Company A. Thus, with new businesses from the investor, Company A is in a position to report profit soon and have its "ST" status removed subsequently.

Unlike reorganisation cases elsewhere, almost all reorganisations in the PRC will require full repayment of employee claims, as well as taxes owing to the Government.

Back-door Listing

The practical effect of virtually all reorganisation of "ST" listed companies is for the company "shell", i.e. the listing status, to be sold to a new investor. This is similar to the "back-door listing" arrangements which were very popular with the "restructuring"[13] of listed companies in Hong Kong during the Asian Financial Crisis in 1997/98.

In another earlier survey conducted by Grant Thornton on the "destiny" of these "back-door listings" in Hong Kong during the period from 1998 to 2004[14], the vast majority of these "restructured" companies did not survive long. Many had to undergo another "restructuring" soon afterwards, or were simply liquidated.

"Bankruptcy" Provisions in Listing Rules

The China Securities Regulation Commission introduced a new section "Bankruptcy" to the Listing Rules of the Shanghai and Shenzhen Stock Exchanges with effect from September 2008. Related administrative measures include:-

1. Administration Measures for Significant Asset Reorganisation of Listed Companies (with effect from 18 May 2008);

2. Supplementary provisions for Determination of Share Price for Shares to be Issued in the course of significant Asset Reorganisation of Listed Companies Bankruptcy Reorganisation (with effect from 12 November 2008)

A listed company is obliged to report, as required under new provisions of the Listing Rules, to the Stock Exchange when a decision to make an application for bankruptcy, restructuring or reorganisation ("Insolvent Related Administration") is made by the Board or by creditors of the listed company.

Disclosure of further information associated with the Insolvent Related Administration is required when the application is duly accepted by the court. The information to be disclosed includes but is not limited to the name of applicant; the date and reasons for accepting the application; contact details and duties for the administrator; name of person who is responsible for the disclosure of information etc. Extensive details related to the reorganisation proposal should be reported to the Stock Exchange in the course of the reorganisation period.

ST listed company subject to the Insolvent Related Administration should also observe the disclosure requirements determined under the particular provisions for special treatment.

Bankruptcy of Non-listed Companies

Since 1 June 2007, some 6,000 non-listed companies have been subject to the New Law, almost all of which were bankrupted (liquidated). There have been very few reorganisation cases. Courts in general have been very conservative if not reluctant in “accepting” bankruptcy petitions for three main reasons: firstly, the courts in general do not have sufficient resources to deal with large numbers of bankruptcy cases; secondly, the courts do not have sufficient experienced judges to handle bankruptcy matters; and thirdly, courts are awaiting the Supreme People’s Court to issue the “working rules” for bankruptcy cases[15].

[13] The writer tends to refer to the rescheduling of legal and financial obligations as "restructuring"; whereas "reorganisation" would involve operational reform.
[14] From sources obtained mainly from the respective companies' annual reports, announcements, related press reports and other publicly available information, Grant Thornton Hong Kong has conducted a survey of listed companies that have been involved in some form of reorganisation from the period from 1998 to 2004.
[15] It is expected that these “working rules” or interpretations of the New Bankruptcy Law will be issued by the year-end of 2009 or early 2010.

Take Beijing as an example. From 1 June 2007 to 29 June 2009, there were 55 bankruptcy cases pronounced and 53[16] allocated to administrators through the panel system of the Higher People's Court of Beijing. For each of these cases to be allotted, all panel members[17] are invited to attend a lot-drawing session at the Court with no prior knowledge or information on the number of cases to be allocated or the nature of cases to be involved. Those firms which have earlier allocation of cases need not attend as they will not be given a chance to draw from the lots until each of the 100 firms on the panel has been allocated one case. Also, those not attending will not be given a chance to draw – only those firms physically represented and present (and who have not been allocated a case in the first round of 100) can take part in the lot-drawing. The lot-drawing is supervised by all parties attending. So far, all cases from the Beijing court have been small to medium sized local bankruptcy cases.

It is observed that the courts have been given a far too important administrative role to play in bankruptcy proceedings under the New Law (similar to that under the Old Law). Yet, the judges in general are reluctant to be too active (or innovative) in dealing with cases under the New Law as they are unsure of the detailed practice and procedures under the same, as the "working rules" and interpretations have yet to be announced by the Supreme People's Court. Besides, there is still a very large influence of the local government over which cases should go before the court.

International Implications

The PRC legal system in general is still seen by many as closed and opaque. International lenders still remember the tough negotiations they had to do and the frustrations they experienced in the cases of GITIC, GDE and many other "itics" during the Asian Financial Crisis. Thus, it is inevitable for one to ask the question: what are the ground rules and parameters for international insolvencies under the PRC regime in general and the New Law in particular[18]?

China's general attitude towards recognition and enforcement of foreign court judgments, according to Article 268 of the Civil Procedure Law[19], is:

- based on international treaties and bilateral agreements to which China is a party and based on reciprocity, and on a case by case basis, the PRC courts may, on the basis that doing so will not impair the sovereignty and security nor jeopardise the social and public interests of China, recognise and execute foreign court judgments; and

- PRC courts may not recognise nor execute any foreign court judgments and rulings in cases over which the PRC courts have jurisdiction. After having been recognised or executed by PRC courts, foreign court judgments and rulings may have an equal effect with orders made and given by a PRC court.

The Civil Procedure Law[20] and relevant bilateral judicial assistance agreements often have the following stipulations concerning the procedures for recognition and execution of foreign court judgments and rulings:

- Requests for recognition or enforcement of foreign court judgments may be lodged with the relevant People's Courts with jurisdiction. Enterprise bankruptcy cases are administered by the People's Court in the place of domicile of the debtor, determined by the location of the main business organization or office of the debtor. If the debtor has neither a physical

[16] Two cases were subsequently rescinded or withdrawn by the court. A similar number of cases have been pronounced by the courts in Shanghai.
[17] There are 100 firms of administrators on the Beijing (non-individual) panel: 65 legal firms, 33 accounting firms and 2 bankruptcy firms.
[18] See Chapter 6, "Insolvency in China and Hong Kong – A Practitioner's Perspective" written by the writer and published by Sweet & Maxwell, Asia in 2005.
[19] Article 268: "If a people's court of the People's Republic of China, after its review in accordance with the international treaties concluded or acceded to by the People's Republic of China or on the principle of reciprocity, considers that the legally effective judgment or order of a foreign court which requires recognition and enforcement does not contradict the basic principles of the law of the People's Republic of China nor violates the state and social, public interest of China, it shall render an order on the recognition of its force
[20] Article 262. In accordance with the international treaties concluded or acceded to by the People's Republic of China or on the principle of reciprocity, the people's courts of China and foreign courts may request each other's assistance in the service of legal documents, in investigation and collection of evidence or in other litigation actions.

location of their business organisation nor office, the People's Court of the location of the debtor's registration may administer the case.

- Recognition or execution of foreign court rulings may be requested either by the litigant or the relevant foreign court in accordance with the international treaties, judicial assistance agreements or reciprocity entered into by the foreign country and China. In the absence of any international treaty or reciprocity agreement, the foreign court may request assistance from the courts in China through diplomatic means.

- The PRC court will then review these requests in accordance with the relevant international treaties or agreements. The review is only restricted to whether the foreign court judgment is in conformity with Chinese legal provisions or with the terms and conditions for recognition and enforcement of foreign judgments as stipulated in the treaties or agreements. Matters regarding findings of facts and application of law may not be reviewed.

Following such a review by the People's Court, foreign court judgments may be recognised and executed by the PRC courts if the following conditions are met:

- according to Chinese law, the local court that deals with the application for recognition and enforcement of the foreign judgment shall have proper jurisdiction[21];

- according to the law of the country in which the judgment was made, the judgment has become effective[22];

- the lawful rights and interests of the litigants have been and are duly protected;

- in respect of a case with the same litigants involving an identical object of the action:

  (i) a PRC court has already made a legally effective judgment on the case;

  (ii) the matter is being heard by a PRC court; or

  (iii) a PRC court has recognised the judgment of a court of a third country and the judgment has become legally effective in China; and

- the judgment is in conformity with the principles of Chinese law and does not impair the Chinese sovereignty and security nor the Chinese social and public interests[23].

After reviewing, the court may decide to recognise the foreign court judgment and issue an enforcement order; or decide to deny recognition. In short, it would be relatively much simpler if the court order one is seeking for enforcement is from a court of a nation which has already had judicial assistance treaties signed with China, or a co-signing nation to international conventions to which China is a party. However, in cases where there is no judicial assistance treaty between the country of the foreign court and PRC, foreign judgments or judicial assistance may also be sought from a court in China on the grounds of reciprocity. Laws giving effect to these foreign judgments are contained in Articles 262 to 269 of the Civil Procedure Law of the PRC, with the principle of reciprocity being specified in Article 262. The application for enforcement of the judgments may be raised by the overseas court granting such an order or the parties to the case (Article 267). According to Article 263, such assistance can also be sought through diplomatic agencies, i.e. the consulates or ambassadors, of the relevant countries.

[21] Civil Procedure Law of the PRC, Articles 243 and 267.
[22] Civil Procedure Law of the PRC, Article 267.
[23] Civil Procedure Law of the PRC, Article 268.

Provisions similar in nature to that in the Civil Procedures Law have been incorporated in the New Law[24].

Thus, from a practical point of view, and for the purpose of "out-bound" bankruptcy cases from China concerning assets overseas, the law and practice from China's perspective is, on a unilateral basis, very clear. The Old Law is silent in this regard. The Supreme Court's Opinion in respect of the Old Law (1991) is also silent. Given that the main purpose of the Old Law is the reform of State-owned enterprises, which in the 1980s had relatively few assets overseas[25], it is fair to say that the idea and concept of State-owned enterprises in bankruptcy in China having assets overseas was simply not a major issue being considered in the course of the drafting of the relevant legislation[26] at the time. The underlying thinking at the time was that "territoriality" should apply in respect of "in bound" bankruptcies and "universality" in respect of "outbound" bankruptcies, giving China and local creditors practically speaking the best "protection" of both worlds.

It was not until the bankruptcy of GITIC in 1999 that the situation of State-owned enterprises in bankruptcy with assets overseas was encountered in a major scale[27]. Thus, there was a change in the Supreme Court's Rules (2002) with the addition of Article 73, which required the liquidation committee to recover the debtor's assets which were located outside the territory of the PRC. As a result of this change, a PRC domiciliary bankruptcy now would formally aspire also to extend to cover assets in overseas jurisdictions and that the liquidation committee appointed under PRC law was both entitled and obliged to seek to obtain control of and dispose of these assets overseas.

To conclude, there are clear legal provisions and precedents in the PRC to deal with both in-bound and out-bound cross-border insolvencies and reorganisations. It is of paramount importance for international investors and insolvency practitioners to be aware of these laws and practices. Article 5 of the New Law on cross-border insolvencies has not been tested through the courts so far.

Closing Observations

For cultural and other reasons, China never had any bankruptcy law until 1906, despite the thousands of years of civilisation and international trade. However, the true operation of any bankruptcy law did not start until 1988 in the form of the Enterprise Bankruptcy Law (Trial Implementation) for State-owned Enterprises in the PRC. Yet, China has gone a very long way already in the last 20 years or so by building on the concept of bankruptcy and reorganisation in reforming and transforming the SoEs, including and in particular the banking sector, and the economy in general.

The PRC Stock Exchanges now (following the global financial crisis) have local PRC listed banks ranking as the largest banks globally. Yet, in terms of the law and practice in bankruptcy and reorganisation, the PRC is still at an infancy stage on the international scene. The new Enterprise Bankruptcy Law is now applicable to virtually all forms of business enterprises in the PRC. The ST-A share companies have been particularly quick to adopt the reorganisation procedures to transform themselves by effectively introducing new investors through "back-door" listing, thus salvaging and saving the otherwise financially dead listed shell.

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[24] Article 5 of the New Law, which states "The Procedures for bankruptcy which have been initiated according to the present Law shall have binding force over the assets of the relevant debtor beyond the territory of the People's Republic of China. Where any legally effective judgment or ruling made by a foreign court involves any debtor's assets within the territory of the People's Republic of China and if the debtor applies with or requests the people's court to confirm or enforce it, the people's court shall, according to the relevant international treaties that China has concluded or acceded to or according to the principles of the reciprocity, conduct an examination thereon and, when believing that it does not violate the basic principles of the laws of the People's Republic of China, does not damage the sovereignty, safety or social public interests of the state, does not damage the legitimate rights and interests of the debtors within the territory of the People's Republic of China, grant confirmation and permission for enforcement".

[25] An exception may be the "itics" many of which were closed during the Asian Financial Crisis.

[26] As confirmed by Mr Cao Siyuan (Chairman of the Drafting Committee for the old Bankruptcy Law) in December 2004 with the author.

[27] Although in the now repealed (in 1993) "Shenzhen Special Economic Zone Bankruptcy Rules for Companies with Foreign Interests" (July 1987), there is a provision that "… a bankruptcy declared by a PRC court shall have effect over the assets of the bankrupted enterprise overseas …" (Article 5).

Like many other countries, China deals with assets physically in the PRC using local laws. Cross-border insolvencies will likely remain issues of relatively low priority for the PRC perhaps until the days when there are substantial PRC outbound investments in the international arena, as by then the issues of insolvency reciprocity would be closer to the heart of many a Chinese entrepreneur and the Chinese government.

Chinese medicine and medical practice have been mysteries to many, including the average Chinese, for centuries. Perhaps, how the PRC has managed to reform and transform the economy and the massive State-owned Enterprises sector without any sophisticated bankruptcy and reorganisation law would remain equal mysteries to many. Despite the good intentions and sound legal theories behind the New Enterprise Bankruptcy Law, it will still take a lot of political will and government effort to overcome and change the stigma of bankruptcy in the Chinese culture.