The Corporate Reorganization Regime under China’s New Enterprise Bankruptcy Law

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Abstract

This paper reviews the background of embarking on the bankruptcy law reform of China, and examines the newly introduced corporate reorganization regime under China’s new Enterprise Bankruptcy Law 2006. As a patchwork of the US Chapter 11 and English Administration, China’s new regime is a good law on paper with sound intention and perfect logic. But there are still many legal and institutional impediments to the new regime’s utilization. For example there is a serious institutional incapacity among the judiciary, as the necessary training and organization of thousands of professionals has not started. Also of concern is the still-unfinished process of updating and modification of related laws and accounting standards as well as their application and enforcement. Enacting a new bankruptcy law is only the first step. Copyright © 2008 John Wiley & Sons, Ltd.

I. Introduction

Having been 12 years in the making, the draft of China’s new Enterprise Bankruptcy Law passed its third readings required for final approval on 27 August 2006, was thereby promulgated and took effect as of 1 June 2007. It is the first comprehensive and unified Bankruptcy Law that is applicable to all types of incorporated enterprises in this jurisdiction. One of the most outstanding features of the new Chinese Bankruptcy Law is its introduction of a real formal corporate reorganization regime, basically a patchwork of the US Chapter 11 and English Administration, into this jurisdiction for the first time in history. This paper will review generally the background to China’s embarking on its bankruptcy law reform, the framework of the new bankruptcy law,
particularly the procedure and features of the new corporate reorganization regime, and finally the institutional impediments to the new regime's utilization.

II. Background of the Previous Bankruptcy Law

Emerging in the 80s of the last century, the previous bankruptcy system in the People's Republic of China is a long way from being satisfactory. The first Chinese insolvency legislation, Enterprise Bankruptcy Law (for Trial Implication), promulgated in 1986 as the primary law of the previous system, with complementary opinions and policy documents, was confined only to the state-owned enterprise (SOE) sector. The Chapter 19 of the Code of Civil Procedure 1991 functioned as a minor insolvency law and directed at other forms of legal person of private and joint venture sectors. A number of other laws and regulations directed at special types of legal person of financial sector or were only applicable in limited localities. Besides its blameworthy inconsistency and oversimplification in drafting, viewed from an economic perspective, the whole system, particularly the 1986 Bankruptcy Law, was designed only to meet the conditions of the then emerging so-called 'planned market' economy. A debtor enterprise cannot apply for bankruptcy without the agreement of its superior departments in charge, typically the government branch that should preside over the organization thereafter. The immaturity of the security interests system and the effect of regionalism usually failed to provide the secured creditors, typically state-owned banks, with recognized and protected priority positions. Compelling enterprises to improve their management and operation by providing a deterrent to inefficiency, rather than dealing with creditor and debtor relationship and providing an efficient mechanism for terminating the enterprise, may fairly be said to be the original guideline of the previous bankruptcy system.

Concretely, the composition/reorganization proceeding in the 1986 Law was in fact a joint proceeding of government-controlled renovation and composition, not a

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3. Art. 8 of the Enterprise Bankruptcy Law (for Trial Implication) 1986.
real reorganization regime in its accustomed meaning. There were only six provisions that deal with this composition/reorganization proceeding, and no detailed techniques and protective measures. Administrative factors played a major role in bankruptcy proceedings and distinguished the previous system of China from that of the West. The lack of incentive for any party—management, employees, unsecured creditors, government or even secured creditors—to utilize the previous composition/reorganization regime was further accentuated by the uncertainty of what was going to happen upon its utilization. For enterprises being subject to soft budget constraints, their viability hardly can be analysed accurately and therefore fails to be the key to judge whether they should be kept alive or shut down. The aftermath is inefficiency, like an infective plague, spread to every part of the state-owned economy. Not surprisingly, this proceeding was extremely under-utilized since its implementation, partly because of the obstacles rooted in the social-economic environment of China in the past decades, and partly because of the impracticability of the regime itself.

Today, the economy of China has experienced great transformation and development. First, private and foreign joint venture enterprises increased in sheer numbers and occupied a great proportion in competitive industrial sectors in terms of production and contribution of taxes; and their influence on the Chinese economy will inevitably keep increasing in the further without doubt. A more updated legal system aimed to encourage and protect investment and credit extension is eagerly expected. Second, the market of China has become increasingly competitive and this tendency will continue in all enterprise sectors. Failure of enterprises has become a common part of every day life and the society began to get used to the concept of bankruptcy. Third, the concept of state-owned enterprise has become confusing. The lack of a

6. Chapter 4 Settlement and Reorganization, the Enterprise Bankruptcy Law (for Trial Implication) 1986.
7. The superior departments usually had no incentive to bear this burden for the absence of concern in the interests of themselves. Creditors, on the other hand, did not enjoy any protection, influence or control to the whole process. Neither the superior department nor the debtor was accountable for its misfeasance or wrongful activities; there was no incentive for creditors to invoke the conciliation procedure at all. M. E. Monfort, ‘Reform of the State-Owned Enterprise and the Bankruptcy Law in the People’s Republic of China’ (1997) 22 Okla. City U. L. Rev 1067, pp.1105.
8. ‘By “soft” as contrasted with “hard” budget constraints is the situation whereby a budget is fixed for outputs and inputs; yet, for the enterprise unable to live within its terms, the government will, albeit reluctantly, provide additional revenues either directly or through directive to the banks to ease the problem. Under such a system, the management was not forced to take the budget seriously and confront the hard decisions required of an enterprise operating in a market economy where typically hard budget constraints prevail.’ see ibid. pp.1086.
9. Main structural impediments to the utilization and enforcement of previous bankruptcy law included inaccurate analysis of a company’s efficiency; the potential for unemployment; the absence of social security system; unreasonable government intervention on the bankruptcy of SOEs; the interconnection between the judiciary and the administrative authorities; the prevalence of triangle debts between SOEs, and the inefficiency of state-owned banking system.
10. First, the standard for bankruptcy is vague. For instance, there are no criteria to establish what constitutes “heavy debts.” Second, the Bankruptcy Law has no provisions dealing with preferences among creditors. In addition, there is a dual standard regarding when creditors, as opposed to debtors, may petition for bankruptcy. While a creditor may file whenever the debt cannot pay its mature debts, the debtor may only file if the heavy debts result from mismanagement. Furthermore, the 2 year deadline by which the estate must complete a reorganization may be unnecessarily rigid and force debtors into liquidation merely because they are unable to comply with the deadline; see S. Cho, ‘Continuing Economic Reform in the People’s Republic of China: Bankruptcy Legislation Leads the Way’ (1996) 19 Hastings Int’l & Comp. L. Rev 739, pp.750.
prescribed definition in statutory provisions makes it difficult to legally distinguish SOEs from non-state enterprises. With the introduction of more non-state capital, through direct foreign investment, into SOEs, and particularly with the establishment of stock exchanges in China, large proportion of SEOs has been transformed into public or limited liability companies. The diversity of state shareholdings makes disparity of the treatment between SOEs and non-state enterprises neither sensible nor necessary. A more market-oriented and efficient uniform bankruptcy system with managed flexibility is needed in a new era.

III. Details of the New Reorganization Regime of China

As a unified law covering all types of incorporated enterprise, the liquidation of an organization other than an enterprise as a legal entity may also use the procedure set forth in this new law to liquidate and dissolve. Unlike the previous Enterprise Bankruptcy Law 1986, the new enterprise bankruptcy procedures now are applicable to state-owned and non-state-owned companies with legal person status alike bar a carve-out for financial institutions and certain state-owned enterprises.

To highlight their preference, the legislators put the chapters of reorganization and conciliation before the liquidation. The conciliation under the new law bears several features of the previous composition regime. The debtor may petition for court ruling for the commencement of the procedure and propose a settlement of its debts with its creditors. The settlement agreement must be adopted by a simple majority of the creditors with voting rights present at the meeting, holding not less than two thirds of the total unsecured claims; otherwise, the court shall declare the debtor bankrupt and a liquidation will follow. The history of the previous composition regime indicates that it has rarely been utilized since the enforcement of the previous law. Thus, it is estimated reasonably that the new regime still will be seriously under-utilized.

One of the most outstanding features of the new Chinese Bankruptcy Law is the introduction of a real formal corporate reorganization regime, basically a patchwork of the US Chapter 11 and English administration, into this jurisdiction for the first time in history.

A. Access

The new reorganization regime is applicable to all types of companies with legal person status. State-owned enterprises, within the time limit and scope prescribed by the State Council, and financial institutions, such as commercial banks and insurance companies, shall be governed by specific regulations and the measures made in accordance

12. Art. 2. The concerns over the availability of judicial resources, the absence of personal property registration system and immature credit-based social environment abort the inclusion of the once proposed partial individual insolvency regime.
with the law respectively. A reorganization procedure can be petitioned both voluntarily and involuntarily and is commenced upon ‘acceptance’ by the court, which will give rise to a moratorium (‘automatic stay’) against enforcement proceedings and preservation measures. After a bankruptcy application is accepted by the court, the civil or arbitration proceedings the debtor is involved, which have commenced but not yet terminated, shall be suspended for the time being and continue after the trustee takes over the estate. Any new related disputes over debtor’s property or debts can only be presented to the same bankruptcy court, after bankruptcy acceptance.

B. Insolvency tests

The liquidation test under the new law is the combination of both ‘balance-sheet’ test which is established on whether the debtor’s assets are insufficient to satisfy its liabilities and ‘cash-flow’ test which is based on the fact that the debtor is unable to pay its due debts.

The reorganization test reads: when a debtor comes under the circumstances as described above, or is facing the possibility to lose the ability to pay off a debt apparently, the debtor may be reorganized in accordance with the relevant provisions. It seems that the wording ‘facing the possibility to lose the ability to pay off a debt apparently’ is ambiguous. There is a compelling need for complementary rules, in the form of interpretative opinions of the Supreme People’s Court or implementing regulations, to clarify what evidential burdens have to be surmounted in deciding the threshold requirements.

C. Trustee and creditors’ committee

The new Bankruptcy Law can be characterized as trustee-dominant. The trustee is appointed by the court upon its acceptance of the bankruptcy petition in the case. The new law provides that only the courts have the power to appoint trustees and determine their fees, with the purpose of ensuring the impartiality of the trustees. However, it is unclear to what extent an applicant may propose a nominee for the appointment. The trustees could be qualified organizations, institutions or professional individuals, and are required to participate in professional liability insurance. They shall be responsible to the court but meanwhile under the supervision from the creditors’ meeting and creditors’ committee. The trustee may employ personnel from the debtor enterprise to manage the business operation. The trustee owes duties both to creditors and to the debtor. Breach of duty towards either of these constituencies may result in civil or criminal sanction for the trustee.
Usually, the trustee will assume management of the debtor, being subject to merely one exception, the modified ‘debtor-in-position (DIP)’ approach, which permits the management to apply to the court to continue management of the debtor under the supervision of the trustee. Article 73 provides that upon the application of the debtor and the approval from the court, the debtor may manage its property and business operation under the supervision of the trustee during reorganization. In this case, if a trustee has already been appointed, s/he must return possession to the debtor and turn her/his role to a supervising one. The modified debtor-in-possession regime functions as the exception to the trustee-controlled reorganization regime. Although the standard for court approval is unsure, a promising DIP approval may encourage an earlier reorganization petition based on self-anticipated insolvency to some purpose.

The trustee is entitled to perform general functions under Art. 25; to borrow money subject to restricted use and necessary control; to grant lenders security interests in unencumbered properties during the reorganization period; to recover the unusual income and property that the management has embezzled or obtained illegally by other means; to dissolve or continue to perform executory contracts that are established before the petition or to take back the encumbered assets in order to continue operation, if only substitute guaranty is provided.25

The creditors’ meeting may select and appoint creditor representatives to form a creditors’ committee, whose members may not exceed nine persons and, in which, there shall be one labour creditor representative.26 The trustee is required to promptly report on his/her major activities to the creditors’ committee which has been granted supervising powers.27 It appears that the legislators intend to improve the corporate government of the debtor during the period of reorganization by virtue of the creditors’ committee approach. But the new law left lacuna in whether the committee should be allowed to propose a rival plan and solicit acceptances or rejections after the expiration of debtor’s statutory exclusivity period but without a proposed plan. Also missing from the new law is the standard of compensation to be paid to the creditors’ committee. The experience of U.S. Chapter 11 indicates that unsecured creditors usually have little incentive to pursue recovery of their claims by serving on a creditors’ committee when the time expended by them is not compensable and most of the benefit arising from their work will be enjoyed by non-participating unsecured creditors.28

D. Time scale and proceeding

The new reorganization regime is a court-supervised procedure that can be divided into commencement, formulation and approval of a reorganization plan, and implementation stages. The first stage, commencement period, starts with the petition of reorganization to the court. There are two kinds of petition: initial petition or transfer petition.29 Initial petition is the one which the debtor or creditors apply for

25. Art. 18, 34, 36, 37, 75.
27. Art. 69.
29. Art. 70.
reorganization directly to the court when they file an application to trigger the bankruptcy process. Alternatively, after the court accepts the bankruptcy case as a liquidation application, but before the debtor is declared bankrupt, the debtor or the investor who holds more than one-tenth of the debtor’s registered capital may apply for reorganization to the court. The reason for empowering investors, who are usually supposed to have more information advantage to outsiders, to commence the transfer petition is because their intention to reorganize the distressed debtor usually represents their intention to support the business continually, also represented their recognition of the viability of the debtor. The flowchart below summarizes the steps required to be taken by various parties from filing to the holding of the first creditors’ meeting:

*Should it be necessary due to special circumstance, this period may be extended for another 15 days upon approval by the court at the next higher level. Art. 10.*
The period from the date when the court makes the ruling to approve reorganization to the date when the court decides to approve of the reorganization plan or decides to terminate the procedure is the protective period of reorganization. The flowchart below summarizes the described steps to formulate and obtain approval for a reorganization plan.

During the course of reorganization, a number of factors may cause the termination of the reorganization, upon the application of interested parties to the court, after examination and confirmation through the relevant procedures. These include: the continuing deterioration of the management or financial situation of the debtor beyond the point where there is a possibility to save it; unreasonable delay; activities done in bad faith which have the effect of decreasing the enterprise’s property, or other fraudulent behaviour or a serious impediment that will disable the functions of the trustee caused by the debtor or its employees.

*Art. 79. Upon request of the debtor or trustee with justifiable reasons, the Court may grant an extension of another 3 months.

E. The classification of creditors’ meeting, voting and cram down rules

Creditors who declare claims are members of the creditors’ meeting and may exercise voting rights. Creditors whose claims have not been determined and secured creditors who have not abandoned their priority rights may not exercise the right to vote. Akin to the US Chapter 11, the creditors must be divided into four different classes: secured creditors; labour creditors; taxation authorities and unsecured creditors.

Within 6 months of the commencement of the reorganization period, the trustee or the debtor is to prepare a reorganization plan (Art.79). After the expiration of the time limit, upon the request of the debtor or trustee, the court may make an extension of 3 months if justifiable reasons exist. The creditors’ first voting meeting shall be convened by the court within 30 days after receiving the draft plan of reorganization. The agreement of a simple majority in number of the creditors in the same voting group presented, and a more than two-thirds in value of the settled credit amount may approve the draft plan within this group. The consensus of all groups shall be deemed as the adoption of the draft plan. Where the draft plan is not passed, the trustee or debtor may negotiate with the refusing group(s) and a second voting may be convened after negotiation (Art. 87). The compromise reached by the two sides in negotiation, shall not impair the interests of the other voting groups.

Where the draft plan is still not adopted by the second voting after negotiation, the debtor or trustee may apply to the court for approval of the reorganization plan over the objection of the dissident group(s) when the following criteria satisfied:

1. The secured creditors are fully paid off, the losses incurred by delayed repayment are compensated fairly and the collateral rights do not suffer substantial impairment. It is a functional parallel of the ‘fair and equitable’ test for dissenting secured classes provided in section 1129(b)(2)(A) of US Chapter 11;
2. The labour creditors (employees) and taxation creditors shall be fully paid off, or if the adjusted repayment proportion has been adopted by corresponding voting group;
3. If the repayment proportion of the unsecured creditors obtained according to the reorganization plan is not less than that of the unsecured creditors obtained according to the liquidation procedure at the time when the reorganization plan is submitted for approval, a functional parallel of the ‘best interests’ test described in section 1129(b)(2)(C) of US Chapter 11;
4. If the adjustment made by the draft reorganization plan to the rights and interests of investors is fair and just, or the group of investors has already adopted the plan;
5. If the draft reorganization plan treats all the members of the same voting group on a fair basis and the repayment order prescribed in the reorganization plan does not violate the priority order as described in Art. 113, the conceptual parallel of the ‘no unfair discrimination’ requirement under section 1123(a)(4) and the ‘absolute priority’ rule under section 1129(b)(2)(B)(ii) and (C)(ii) of US Chapter 11;

32. Resolutions of the creditors’ meeting shall be passed by simple majority in number of the creditors with the right to vote present at the meeting; and simple majority in value of the total amount of unsecured credits. Art. 64.
33. Art. 82.
34. Art. 84.
35. Art. 87.
If the management scheme of the reorganized enterprise is feasible, the conceptual parallel of the 'feasibility' test prescribed in section 1129(a)(1) of US Chapter 11.

The court shall make a ruling of approval, or in other words, utilize its limited 'cram down' power to compel the enforcement of the draft plan within 30 days after the application where it thinks that the plan submitted by the debtor or the trustee meets the above requirements. Where the creditors' meeting fails to pass the draft plan in the second voting and the plan cannot satisfy the requirements of cram down, the court shall make a ruling to terminate the reorganization and declare the debtor bankrupt (Art.88).

**F. Continuing financing**

Continuing financing during the reorganization period is the key of a successful reorganization and the most compelling matter the financially difficult debtor must face up to. Any legislation aimed to provide a workable reorganization regime could hardly keep silence in this regard. The new law provides some simple continuing financing mechanisms along the line of US Chapter 11 DIP financing. As the functional parallel of administrative expenses in US Bankruptcy Code, bankruptcy expenses and debts of common benefits prescribed in the new law can be deducted from the bankruptcy property altogether prior to the repayment to any other unsecured creditors and shall be paid off at any time with debtor's property. Where the debtor's property is insufficient to pay off all of the bankruptcy expenses and debts of common benefits altogether, the former shall be the first to be paid off. The new law further prescribes:

1. The debts that the debtor bears during reorganization in order to continue business operation are debts of common benefits. These post-petition debts, therefore, enjoy priority over all pre-petition unsecured debts, akin the administrative priority prescribed in Section 364(a) and (b) of the US Bankruptcy Code.

2. Where the promise of a common benefit priority may not enough induce a post-petition credit extension, the debtor may take the property that has not yet been encumbered to secure the incurring of new debt. The 'new collateral' or 'free property' priority is the functional parallel of the non-priming liens prescribed in Section 364(c)(2) of the US Bankruptcy Code but with narrower coverage. The free property of the debtor may come from two sources. Firstly, because of the absence of the functional parallel of floating charge in China, the existence of free property that has not yet become the subject matter of the secured rights is possible, at least in theory. Secondly, the free property may come from the assets obtained after petition. It is suggested that allowing the debtor to secure post-petition loans with security interests in unencumbered assets is the most effective way to attract continuing financing during reorganization.

Beside the confidence brought to post-petition creditors, the new collateral priority

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37. Art. 41.
38. Art. 42.
40. Art. 75.
coming into being by encumbering the post-petition assets is a more reasonable ‘limited priority’, which is less likely to stimulate the debtor’s moral hazard on overinvestment,\(^\text{42}\) instead of an ‘across the border priority’ against the value of all assets like the administrative expenses priority.

The continuing financing mechanism prescribed in the new law is simple and workable, at least in theory. It is also suggested that necessary control and supervision shall be performed on the post-petition loan’s usage. The complementary rules for its application therefore are looking forward.

**G. Implementation of a reorganization plan and exit routes**

The third stage of the reorganization regime is the implementation or supervision period. After the court approves the reorganization plan, the trustee that has been in charge of the management shall deliver property and business operation to the debtor and then be in charge of the supervision of the plan’s implementation. The debtor shall report to the trustee the plan implementation and financial situations of the enterprise. Not until the supervision period ends and submission to the court supervision report, the trustee shall not be released his/her supervision duties. Where the debtor is unable to or refuses to execute the reorganization plan, upon the application of the interested party, the court shall decide to terminate the execution of plan and announce the debtor bankrupt.

**H. Priority order, special priority of labour-related claims and the justifications for extraordinary emphasis upon workers’ protection in China**

As a principle, the new law provides that the court shall safeguard the lawful rights and interests of the employees of the bankrupt enterprise in accordance with law when trying bankruptcy cases.\(^\text{43}\) The normal priority order under the new law remains the priority scheme of the 1986 law (section 37), in which a secured creditor is described as a right holder who enjoys the exclusive priority right to the encumbered property (collateral) of the bankrupt. Then after deductions of bankruptcy expenses and debts of common benefits from the bankruptcy property, repayment shall be made in the following order: (1) the labour-related claims;\(^\text{44}\) (2) the social insurance contributions owed by the bankrupt other than those included above and the taxes owed by the bankrupt; and (3) the unsecured creditors of the bankrupt.\(^\text{45}\) Where the assets are insufficient to pay all of the claims within a single ranking in full, \(^{42}\) For example, the DIP financing might be secured by only post-petition assets. With respect to pre-petition assets, the lender continues to rank equally with pre-petition unsecured creditors. As illustrated below, the flexibility to grant such a limited priority may provide a solution to the underinvestment problem superior to that offered by an across the board administrative expense priority. See G. G. Triantis, ‘A Theory of the Regulation of Debtor-in-Possession Financing’ (1993) 46 Vand. L. Rev. 901, pp. 925–926.

\(^{43}\) Art. 6.

\(^{44}\) Consists of the salaries, expenses for medical treatment, injury or disability allowances and pensions owed by the bankrupt to its staff and workers, the basic old age insurance contributions and basic medical insurance contributions owed by the bankrupt and to be paid into individual accounts of its staff and workers, and the compensations payable to its staff and workers in accordance with the provisions of laws or administrative regulations.

\(^{45}\) Art. 113.
the principle of *pari passu* shall apply. Extraordinary emphasis on workers’ protection was prescribed in the last draft (the 9th draft as presented for the second hearing) of the new law by trying to introduce a special priority of labour-related claims to this jurisdiction. The normal priority scheme proposed in that draft was not different from the one finally passed while Art. 113 and 127 of the draft tried to substantially expand workers’ protection under the bankruptcy law. The draft law Art. 113 provided that where workers’ claims can be paid in full, the normal priority order will apply. However, where there are not sufficient funds to pay worker’s claims, the workers’ unpaid claims get first priority, over the priority rights of the secured creditors, from the encumbered assets. These provisions overthrow the long-standing traditional priority scheme adopted by most western jurisdictions and cut back on the substantial rights of secured creditors seriously.

A hot debate over the justifications of the deviation from the traditional priority scheme aroused. The opponents argue that although it is axiomatic that a country’s bankruptcy regime can reflect the importance of certain social values, failure to respect the agreements made between a debtor and her secured creditors and failure to recognize the role of secured loan plays in financing will break the normal order of the market economy and badly damage the interests of the bank community. On the other side, extraordinary emphasis upon workers’ protection, as the proponents suggested, will serve as a cushion against the social unsettlement brought by large-scale bankruptcy of state-owed enterprises. The deviation from the traditional priority scheme or the considerable dilution of security rights is not necessarily the breach of normal order of the market economy, although the danger that labour-related claims can easily exceed the value of the encumbered property and therefore will leave nothing to secured creditors is so compelling in China. This conclusion is to be drawn both from the theoretical perspective, and from the unique historical backgrounds and reality of China.

In theory, the freedom of contract argument has to constrain its force where the contracts concerned are not bargains among equals and will affect the benefits of third persons. Most of the unsecured creditors, including employees, are non-adjusting creditors who can neither adjust the size and condition of their claims against debtors to response to the existence of the security interest nor perfectly consider and reflect all the negative impacts of secured lending on their own interests. On the other hand, the secured creditors are absolutely voluntary creditors whose claims can be insulated from any impact introduced by the agreements between the debtor and her other creditors. The secured creditors usually are those institutional lenders who have informational advantage, economies of scale and therefore can easy

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46. Ibid.
obtain strongest bargaining position. In most circumstances, debtors grant a security interest to creditors not because they choose to do so, but because they have no other choice. As the outcome of ‘path dependence’ of traditional security law system, the current distributional norm in the bankruptcy system in the form of the traditional priority scheme is the one that allows the secured creditors to pass on most of the external costs to the unsecured creditors. From this perspective, some kinds of loss sharing or interests redistribution in bankruptcy process through direct redistributional vehicles, are reasonable to some extent.

It is nonsense to judge the rationality of introducing the special priority of labour-related claims in general without considering the specific historical background of its genesis. This extraordinary deviation from traditional priority scheme will become more understandable, after counting in the immaturity of China’s social welfare system and the state-owned nature of the current banking industry of this socialistic jurisdiction.

1. The role of state-owned enterprises in history and the absence of established social welfare system

Social insurance and social welfare are two distinct categories of social aid in today’s China. There was no concept of social insurance scheme in this nation before the introduction of the unemployment insurance fund in 1986. On the other hand, social welfare, in the form of a latent social protection 'contract' between the urban SOE workers and the State—the so called 'Iron Rice Bowl' regime—was intact from 1954 to 1990s. The economic core of the famed 'iron rice bowl' concept is that the SOEs paid only minimum wages to the workers but promised to provide them all the SOEs-linked social welfare and necessary pensions they may need after their retirement continually, for the rest of their life. That is to say, workers sacrificed a substantial

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51. The methods of redistribution can be divided into two categories: one is direct and another is indirect. Providing the corporation a chance to reorganize and legislating relative reallocative provisions is the indirect way through which the bankruptcy process can effect loss allocation, through asset deployment decisions. Nevertheless, given all investors bargain with full knowledge of bankruptcy’s redistributive provisions, redistribution hardly can perform a wealth transfer from or to constituents most in need. In terms of capability, judicial or bargaining processes themselves generally are poorly designed to achieve redistributive goals. Because of its certainty on extent and identification, direct redistributial vehicles, such as legislating direct changes in entitlements, progressive taxation, social welfare systems, or direct spending, the ring-fencing fund introduced by UK Enterprise Act 2002 for instance, is supposed to be the better approach to reallocate the losses of business failure.
part of their wage entitlement in exchange with the SEOs’ (in essence, the government’s) guarantees of a comprehensive social welfare in perpetuity. Unlike the cases in a capitalist market economy, whether a Chinese SOE should survive or not does not depend purely on its profitability, given its hidden contribution to social welfare is unmeasurable thus its unavailability cannot be concluded simply from its inability to pay off its due debts. The government, therefore, is assumed to have the responsibility to interfere in the economy by subsidizing SOEs. The founding fathers of the socialistic planned economy never thought of the possibility of bankruptcy and the relevant remedies needed when the SOEs break their promises to workers many years later. China’s transition from a centrally planned economy to a market economy since the 1980s has smashed the old guarantees. Millions of workers have been laid off and left without the welfare benefits they were once promised as SOEs have been restructured or shut down.

The Chinese government has speeded up establishment of a social insurance and welfare system de-linked from enterprises, including unemployment insurance, pensions, medical insurance and housing since the middle 1990s, marked by the introduction of the new Labour Law 1995. Nevertheless, implementation of the mandatory social insurance funds is still in the preliminary stage and completion of a new social welfare framework including medical care and education system will take years or more likely decades. In the interim period, however, the scope of reform of insolvent SOEs is to be expanded and there is a general lack of adequate funds within distressed SOEs to finance employee severance packages. The levels of compensation must serve to some extent a political function by mitigating the social unrest caused by widespread unemployment.

2. The non-performing debts of state-owned banks and the nature of the secured debt subordination

Since the emergence of means of direct financing, and the development of markets of negotiable securities, is an event that happened in China a mere 20 years ago, state-owned bank loans were for a long time the most important source, if not the sole source, of the working capital for the majority of SOEs. Before the establishment of the commercial banking system in the late 1980s, the loans of banks were arranged according to policy and administrative orders. The commercialization of the operations of the state-owned banks in 1995 did not change the situation too much for the time being. Because of the combined aftermath of inefficiency caused by the government’s interference, bureaucratism of state-owned banks themselves, localism and the bifurcation of the interests between local governments and banking system...

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55. ‘State-owned bank loans comprise as much as 95% of the working capital for some SOEs. SEOs and the state banks, upon which they are heavily dependent, are engaged in a “triangular debt” whereby the SOEs, state banks, and the state are linked together in a cycle of debt exchange’. See ibid, pp.750.
controlled by central government, the proportion of bad loans to the outstanding loans in all the state-owned commercial banks' assets is extraordinarily high, by Western accounting standards for the banking industry. To protect the stability and safety of the financial system has become of the pivotal link of the chain of SOEs reform. In 1995, China promulgated the Commercial Bank Law, making legal requirements for the safety of bank assets, nevertheless, these requirements with honourable intentions caused unthought-of aftermath:

Aiming at the mess of bad assets in commercial banks that were increasing strikingly, the Central Bank strengthened the control and supervision over the commercial banks and demanded that the ratio of all the commercial banks' bad assets be dropped by 2–3% each year. Under this pressure, the commercial banks came up with two 'countermeasures'. One was called 'shifting loans', i.e. concealing the real bad assets artificially in the book entries by making new loans to pay off the old loans, which in fact accumulated the potential financial crisis. Another was called 'reluctant to loan', i.e. no loan would be made unless there was 100% certainty of repayment, a practice which not only led to considerable interest losses, but also worsened the distress of SOEs, which would finally result in the loss of bank assets.

The result is that all SOEs lost their financial liquidity and had no unencumbered assets left at all. On the other hand, banks generally lost their competence to promptly respond to market signals. Unemployment and the natural predicament of the banking system thus became the two sides of the coin of SEOs' systemic failure.

56. ‘Local governments play numerous roles in SOE bankruptcy. They commonly own the debtor, are among the creditors (social security and tax organs), hold equity stakes in some of the trade creditors, are affiliated with guarantors of some debt involved, and own and charge levies on the land used by the debtor enterprise. Local governments are also responsible for social stability and minimum welfare. . . . Notably absent from the multiple roles of the local governments is ownership or fiscal responsibility of the main creditor banks. These are first and foremost the nation-wide SCOBs under the central government. In an attempt to control financial stability and limit fiscal impact, the central government has been deciding the debt write-off quota under the CSOP and curtailing additional debt write-off through, among other things, the tight cap on loan loss provisions’. SeeThe World Bank ‘Bankruptcy of State Enterprises in China—A Case and Agenda for Reforming the Insolvency System’ (2000), pp.36–37.

57. It is shown in an investigation that the amount of bad loans reached 22.65% of the outstanding loans in the period in the commercial banks' assets in 1995. Of the amount of bad loans, over-due loans accounted for 13.99%, non-performing loans 6.67% and bad debts 1.99% in all the loans of the same period. However, the actual situation was much worse than those figures. Furthermore, about 60% of the non-performing loans had turned into bad debts. Thus, on the basis of the calculation, the actual proportion of bad debts in the outstanding loans in the corresponding period would have reached to 5.99%’. See W. Wang, ‘The Bad-Assets of Banks and Corporate Rescue in China’ (2002), on 20 November 2005, from http://www.iiiglobal.org/country/china/Bad_Assets_and_Corp_Rescue.pdf, pp. 3–4. According to the Central Bank’s report, estimates of China’s NPLs range from almost 18% to about 40% of total loans outstanding at the end of 2003, which may represent as much as 40% of China’s forecast 2004 GDP. The vast majority of the NPLs are owed by SOEs to China’s four state-owned commercial banks. The NPLs account for 21.4% to 26.1% of total lending of the ‘Big Four’ in 2002. In contrast, other developed nations have NPL ratios of 2–3%. By Western accounting standards, 75% of specialized banks are insolvent.


59. ‘Since 1998, some 26 million workers have been laid off from state-owned enterprises. That does not include 6 million not registered as unemployed but who draw little or no salary from their state jobs. Nor do the official figures capture the 80 to 100 million rural migrants swarming cities in search of work, nor the 160 million jobless and underemployed still in the countryside’. See D. Roberts, ‘The Other Specter: Labour Unrest’ (25 November 2002), from http://www.businessweek.com/magazine/content/02_47/b3809167.htm.
To a great extent, the special priority of labour-related claims is not something new at all. Since 1994, the State Council has issued several policy decrees to address problems involving the bankruptcy of SOEs by providing special treatment for the resettlement of workers to all the cities in China. It was provided that the land use rights obtained by a SOE in any city, no matter whether they are encumbered, were to be sold by auction or tender with the first priority to the proceeds to be used for the resettlement of the employees.\textsuperscript{60} That is to say, the workers’ resettlement rights have had priority over secured interests in fact for many years. Thus its embodiment in the draft law is rather to be regarded as a harmonization endeavour among inconsistent legislations.

Finally, the new law shut down this debate by employing ‘a new patients the new treatment’ method and particularly granted the historical labour-related claims superpriority. It is provided that where, after the new law takes effect, the labour-related claims which are owned or are payable by the bankrupt to its staff and workers prior to the date on which this law is promulgated cannot otherwise be repaid in full, the unpaid proportion shall be paid out of the collateral prior to the payment to the secured creditor.\textsuperscript{61} “The labour-related claims which are owned or shall be paid post-promulgation cannot enjoy the favourable treatment any longer.

\section*{IV. Institutional Barriers to the Application of the New Bankruptcy Law in the Future}

\subsection*{A. The trustee: a newly born profession with a prosperous future or a stagnant career being remote from flowering?}

The current reorganization is traditionally characterized as a civil procedure and firmly controlled by court. There is no history of self-disciplinary bankruptcy practitioners in this jurisdiction. Nevertheless, the new reorganization regime will grant trustees functions and powers as broad as those enjoyed by the well trained and organized practitioners in the Western jurisdictions, UK and Australia for instance. It is prescribed that a trustee will be a professional with the necessary expertise and background to perform the responsibilities, either an individual experienced lawyer or certified public accountant or any other relevant public intermediary body.\textsuperscript{62} All details could not be known before the Supreme People’s Court establishes further instructions regarding the qualifications of and appointment methods for the trustees. But thousands of high quality trustees will take many years to be trained and organized. A special license might be required of, then a unified examination as well as local and national associations are expected to be established in the near future.\textsuperscript{63} It has been


\textsuperscript{61}. Art.132.

\textsuperscript{62}. Art.24.


broadly noted that after implementation of the new bankruptcy law, bankruptcy administration will emerge as a new profession in China. Nevertheless, great liabilities and cumbersome assignments but low standard of compensation might impede the utilization of the new regime. The policymakers might not intend to design the new reorganization regime a popular one at all. They might believe that high cost would raise the threshold of utilization and finally increase the proportion of success. Nevertheless, whether this strategy works will remain a question mark to observers for many years.

B. Institutional incapacity of the judiciary

The limited institutional capacity of the judiciary in dealing with bankruptcy cases might be the second obvious impediment to put the new regime into practice. Historically, the interventions of government usually distorted the bankruptcy process by marginalizing the judicial functions of the courts. Chinese judges had to pay great attention to the political concerns of the workers and banks, or the relationship between the administrative authorities and the judiciary, rather than just to the legal concerns of those cases. Absent approval by the government, courts were often hesitant to accept and hear bankruptcy cases. Even if they did accept to hear a case, judges were restrained by the bankruptcy policies of different levels of government, which may appear to conflict with the law. Judges usually hesitated to apply the bankruptcy laws partly because the courts are not entirely independent from other sectors of the government. Support and coordination from the other sectors of the government is necessary for the smooth handling of bankruptcy cases from many perspectives: determining the amount of workers’ settlement; disposing of state assets; transferring land use rights, and fighting against various bankruptcy frauds and crimes.

64. Their compensation is subordinated to workers’ special priority and secured interests, no doubt the chances of repayment will be not good enough in a lot of cases. The regime just emphasizes the logic in paper but may neglect the real incentives to the essential participants. X. Zhang and C. D. Booth, ‘Chinese Bankruptcy Law in An Emerging Market Economy: The Shenzhen Experience Finding from Interviews with Judges from the Bankruptcy Division of the Shenzhen Intermediate People’s Court and Bankruptcy Practitioners in Shenzhen’ (2001) 15 Colum. J. Asian L. 1, p. 21–22.

65. A state authority may now wear two hats at the same time, as both the majority shareholder of a company and as the policy maker with responsibility for the market economy. Thus, many of the interviewees noted that it would be absurd ‘at least in a case commenced by a debtor company’ for a state authority to be responsible for protecting state assets, while at the same time being under a legal duty to deal with creditors fairly. See ibid., pp. 11–12 and ‘Local governments faced with local problems are prone to exert pressure on all of the above to “rubber-stamp” solutions that they believe are beneficial to the local community. But these solutions may not lead to the kind of operational and managerial changes that are necessary to ensure that the enterprise restructuring is sustainable, or that the assets are reallocated in the most economically efficient manner.’ See The World Bank ‘Bankruptcy of State Enterprises in China—A Case and Agenda for Reforming the Insolvency System’ (2000), pp. 36–37.

66. This usually put the judges in a very difficult position for whether special protection should be granted to the state interest to the detriment of other creditors. 67. ‘Debtors have been getting quite clever in carrying out well-planned fraudulent schemes to dissipate corporate assets to the detriment of creditors. The success of their schemes arises from a variety of factors including the lack of coordination between the judiciary and government authorities, the inadequacy of the bankruptcy laws themselves and the lack of bankruptcy court jurisdiction to police fraudulent activities.’ See X. Zhang and C. D. Booth, ‘Chinese Bankruptcy Law in An Emerging Market Economy: The Shenzhen Experience Finding from Interviews with Judges from the Bankruptcy Division of the Shenzhen Intermediate People’s Court and Bankruptcy Practitioners in Shenzhen’ (2001) 15 Colum. J. Asian L. 1, pp. 14.
The lack of capable judges might be another source of irregularities and inefficiencies. The judges dealing with bankruptcy cases have long been those at the economic trial branches (recently renamed second civil courts) of Local Courts, Intermediate Courts and High Courts. Except the one in Shenzhen, the pioneer city of the first five economic special zones in south China, there is no other specialized bankruptcy court in China. Although there are approximately 30,000 judges working in the economic trial courts and dealing with totally 1.5 million economic cases per year, the 5000 bankruptcy cases occupy only 0.3% of the total and therefore the sheer number of qualified bankruptcy judges should be unsurprisingly low. While small groups of judges in large cities generally have accumulated considerable bankruptcy experience, the experience building up of courts in small cities and undeveloped regions will leave less to be expected.

On the other hand, as with the participation of trustees, the court will still play a very important role in the new reorganization regime. It is the court’s responsibility to accept the application, appoint the trustee, direct the trustee and decide the relevant compensations before the first creditors’ meeting, examine and then confirm the proposed reorganization plan, decide to terminate the reorganization procedure in prescribed situations, make a scrutiny into whether a plan can be given a non-consensual confirmation; when it cannot be passed unanimously, etc. Reorganization is a much more complicated procedure which involves broad knowledge and skills in law and business area than liquidation. The negligence and lack of competence of judges will likely lead to huge damages to parties. Although this is required that the court shall form a collegiate bench consisting of three judges to try the bankruptcy case, both the quantity and the quality of current judges still challenges the implementation of the new law.

C. The thin market for the assets of distressed enterprises

Moreover, the reorganization regime is by no means a self-sufficient regime. A developed market for capital assets is also indispensable. It is noted that there is often a discrepancy between the appraisal value of the bankruptcy property and its market value. The existing practice is that the assets’ values are determined by governmental assessment agencies often at levels substantially higher or lower than market values. Selling bankruptcy assets according to their face values seems unacceptable under...

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68. Chinese courts are divided into four levels: the Supreme Court, High Court, Intermediate Court and Local Court. The only specialized bankruptcy trial court was established by the Shenzhen Intermediate People’s Court in December 1993. Until the end of 2000 it accepted 486 cases and closed 373, or averagely 69 accepted and 53 closed per year. These figures tower above all other intermediate courts nation-wide. The specialized bankruptcy judges in the court are 8–10 in recent years. Up to now it has formulated a series of professional instructions, such as the Operating Rules of Bankruptcy Court, the Instructions on Time Limit in Bankruptcy Cases and the Operating Rules of Liquidation Teams. See W. Wang, ‘Strengthening Judicial Expertise in Bankruptcy Proceedings in China’ (2001), on 21 November 2005, from http://www.oecd.org/dataoecd/8/24/1874188.pdf, pp. 3–4.

69. ‘Since they are often asked to transfer their case to higher courts, the opportunity for judges to build up experience is very limited there. Moreover, bankruptcy has not got enough attention in the education of judges. Many of the judges have not got systematic knowledge in bankruptcy law and relative commercial laws such as real property law, contract law, security law and company law, and few of them are able to fully understand accounting reports’. See ibid. pp. 3.
the new reorganization regime. The prices of bankruptcy assets sold through auctions or similar competitive markets will ensure openness, transparency, competition and accountability in asset disposal, and really reflect their real values and be the basis of negotiation. Public auctions for capital assets in piecemeal are necessary; the establishment of use rights of land exchanges at the municipal level should be the first step. ‘Whole takeover’ of bankrupted enterprises should also be operated in more transparent and competitive fashions, through tender with wide public advertisement, and by broadening the access to potential acquirers, even to foreign players.70

The lack of internal bidders or investors usually makes the direct market for non-land bankruptcy assets a thin one. Some more advanced investment channels or markets should be developed. The legal framework and practice of asset securitization should be promoted further. It is also suggested by the World Bank to promote secondary debt and distressed lending markets for the purpose of attracting new working capital.71 The regulatory framework for industrial investment funds, which would cover turnaround funds that purchase loans or equity of distressed firms to turn them around with the objective to sell them later at a profit, should be completed as soon as possible.72 With the opening of financial sector to foreign players and the removing of undue obstacles to the foreign-exchange lending, ‘the access of foreign financial institutions to the future market in Yuan-denominated distressed debt’ should be facilitated and standardized without much delay.73

V. Conclusion

Frankly speaking, the new Chinese Enterprise Bankruptcy Law is a good one with sound intentions. On the whole, the law is the product of a consistent logical process under which the principles of insolvency law have been adapted to the particular policies and social values which are deemed to be fundamental within the social context of current-day China. However, at this stage some further clarifications or modifications are still necessary. For instance, greater clarity is required regarding areas of threshold commencement criteria; provisions for possible amendment of reorganization plan are indispensable generally; and the priority of taxation debts might deserve a reconsideration. The suitable legal policy and workable technological schemes vary from one country to another, being subject to the existing economic structure, legal framework and even cultural traditions of the relevant jurisdiction; there is no universal model. Whether a good law on paper may result in the develop-

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71. A range of actions could help promote such markets. The interest rate ceiling could be relaxed for new lending to firms under court-supervised reorganization and for NPLs that get rescheduled. Writeoffs from sale of NPLs beneath face value could be exempted from the write-off limit of banks. The common requirement that a debtor confirm receipt of the notification of the intended loan transfer to a new creditor and confirm the status of the loan should be relaxed so that the debtors cannot cast doubt on the validity of the transfer simply by withholding his confirmation. The controls against state sector entities selling assets beneath their valuation should be relaxed in the case of assets from foreclosure or liquidation. See ibid, pp. 22.
72. See ibid.
73. See ibid.
opment of a real rescue culture in China depends furthermore on the existence of many other factors and on the effective integration of the interlocking elements. These include: the institutional capacity of the judiciary, the training and organization of thousands of professionals in the working of the new regime, the establishment of some public markets for bankruptcy assets and more advanced investment channels, the general promotion of education in bankruptcy-related matters at law schools, accounting institutes and business schools, as well as the updating and modification of related laws and accounting standards and their application and enforcement. Putting all of these factors in place may take years, but most likely decades, and enacting a new bankruptcy law is only the first step.

74. Not only the group of trustees, but also lawyers, accountants, investment and banking advisors, as well as valuation experts etc.