TWELVE YEARS TO SHARPEN ONE SWORD, BUT CAN IT CUT?
DOES CHINA’S NEW BANKRUPTCY LAW PROVIDE ADEQUATE
PROTECTION FOR FOREIGN CREDITORS?

Submitted by

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**ABBREVIATIONS**

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<th>Abbreviation</th>
<th>Description</th>
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<tbody>
<tr>
<td>BVI</td>
<td>British Virgin Islands</td>
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<tr>
<td>CBRC</td>
<td>China Banking Regulatory Commission</td>
</tr>
<tr>
<td>CDS</td>
<td>Credit Default Swap</td>
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<tr>
<td>EBL</td>
<td>Enterprise Bankruptcy Law</td>
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<tr>
<td>FIE</td>
<td>Foreign Invested Enterprise</td>
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<tr>
<td>GFC</td>
<td>Global Financial Crisis</td>
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<td>JV</td>
<td>Joint Venture</td>
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<tr>
<td>NPC</td>
<td>National People’s Congress</td>
</tr>
<tr>
<td>NPL</td>
<td>Non-Performing Loan</td>
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<tr>
<td>PIK</td>
<td>Payment in Kind</td>
</tr>
<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
</tr>
<tr>
<td>SASAC</td>
<td>State-Owned Assets Supervision and Administration Commission</td>
</tr>
<tr>
<td>SPC</td>
<td>Supreme People’s Court</td>
</tr>
<tr>
<td>SOE</td>
<td>State-Owned Enterprise</td>
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<tr>
<td>UNCITRAL</td>
<td>United Nations Commission on International Trade Law</td>
</tr>
<tr>
<td>WFOE</td>
<td>Wholly Foreign Owned Enterprise</td>
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<td>WTO</td>
<td>World Trade Organization</td>
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ABSTRACT

This thesis investigates the effectiveness of China’s new 2006 Enterprise Bankruptcy Law (EBL) to provide protection to foreign creditors. The unprecedented growth of the Chinese economy over the past decade led to the development of a new bankruptcy regime intended to meet international standards. An analysis of select Chinese bankruptcy cases provides an understanding of endogenous problems with the current business framework, law and regulation in China. This thesis seeks to answer the following question: Does the new Chinese EBL provide adequate protection for foreign creditors? The working hypothesis of this thesis is that the answer to this question is negative: the EBL does not provide foreign creditors with sufficient protection.
STATEMENT OF AUTHORSHIP

Except where reference is made in the text of this thesis, this thesis contains no material published elsewhere or extracted in whole or in part from a thesis or any other degree or diploma.

No other person’s work has been used without due acknowledgement in the main text of the thesis.

This thesis has not been submitted for the award of any degree or diploma in any other tertiary institution.

Signature of candidate: ____________________________

18 October 2010
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1. INTRODUCTION

1.1 Introduction

There is an old saying in China – it takes 10 years to sharpen one sword, which signifies that it takes a long time to fabricate a fine product. In China, it took 12 years from 1994 to 2006, to sharpen the ‘sword of bankruptcy law’.

Jingxia Shi

This thesis investigates the effectiveness of China’s new 2006 Enterprise Bankruptcy Law (EBL) to provide protection to foreign creditors. The unprecedented growth of the Chinese economy over the past decade led to the development of a new bankruptcy regime intended to meet international standards. The new bankruptcy regime raises the question this thesis seeks to answer: Does the new Chinese EBL provide adequate protection for foreign creditors? The working hypothesis of this thesis is that the answer to this question is negative: the EBL does not provide foreign creditors an international standard of the protection.

China is one of the world’s leading economies. The World Bank estimates that it will shortly overtake Japan to claim the number two position in the world behind the United States. China now has the world’s largest population, staggering gross domestic product growth, and many billions of dollars in cash reserves. However, as history demonstrates, all economies have cycles of economic growth and retraction; see for example the recent

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Global Financial Crisis. In every developed economy, there is a need for a bankruptcy law that has the ability to deal with distressed companies and provide creditor protection. China’s new EBL was developed over a twelve-year period from 1994-2006 and represents China’s second attempt at creating a functioning bankruptcy regime that will allow it to deal with failed companies.

The broad aim of this thesis is to undertake an examination of the new bankruptcy regime in China and provide a comprehensive understanding of the development of Chinese bankruptcy law. Many articles written by academics and practitioners have examined previous drafts circulated in the lead-up to and after the implementation of the new bankruptcy law, including discussions of the theoretical problems with its application. This thesis will investigate these issues — such as the development and need for a bankruptcy law — and address numerous other issues that have recently become known after implementation. However, the key focus of this thesis is, as stated, on the protection of foreign creditors.

1.2 Methodology

The research methodology consisted of the following: review of primary sources in official English language translations; a full review of secondary sources including learned journals, press reports and the like, and discussions with experts in the field. As for the secondary journal literature, it is noted that the majority of the current body of literature is theoretical or comparative. There are very little (if any) practical accounts of what is actually happening with the implementation of the EBL. To gain a firsthand account of the situation with regard to bankruptcy in China, the writer made several

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research trips to China and Hong Kong. It is important to note that the author does not speak or read the Chinese language. All materials reviewed have been published in English or an English translation.

The research fieldwork comprised individual discussions and conference attendance.\textsuperscript{4} Individuals contacted were members of the drafting committee for the EBL, senior academics at prestigious universities, partners at some influential global law firms, partners at China-based law firms, bankruptcy restructuring experts and bankruptcy administrators. All these individuals are regarded as experts in their field. Because of the sensitive nature of the discussions, all such talks have been treated as confidential. Where the researcher has derived information from practicing lawyers and administrators, these individuals and the firms for which they work have not been identified owing to confidentiality. A list may be provided to examiners on terms and upon request.

Individual discussions generally lasted between one and two hours. Each discussion was conducted individually and face-to-face at a location that was convenient for the individual. In two instances, discussions were held over the telephone when conflicting time schedules occurred. Due to time, funding and language constraints, only a relatively small number of discussions were conducted. Nonetheless, the personal discussions produced a clear and consistent picture of current bankruptcy law in China. Not surprisingly, access to the most senior and well-respected individuals practicing in the

\textsuperscript{4} Conferences attended: The 2006 PRC Enterprise Bankruptcy Law: A New Beginning Symposium, Institute of Asian-Pacific Business Law, The William S. Richardson School of Law University of Hawaii Manoa, Asian Institute of International Financial Law & Faculty of Law University of Hong Kong, Hong Kong, 25 March 2008; 5\textsuperscript{th} Asian Law Institute Conference, National University of Singapore, Singapore, 22 – 23 May 2008; The International Insolvency Institute 9\textsuperscript{th} Annual Conference, International Insolvency Institute, New York, USA, 18-19 June 2009.
world’s leading international law firms allowed for a relatively high level of confidence as to the accuracy of information.

During the fieldwork, it became apparent that some of the issues identified in the theoretical literature have now surfaced and posed challenges to practitioners. In addition, new issues have arisen that have not been explored previously; for example, alternative approaches to dealing with debtors.

1.3 Structure of Thesis

Broadly speaking, this thesis examines the development of bankruptcy law within China and how it relates to the rights of foreign creditors. Reference is made to what constitutes a good bankruptcy law in the context of international best practice in well-developed bankruptcy systems, such as those of the United States (US). The thesis is developed over seven chapters, each of which comprises several discrete sections.

Chapter 2 examines the historical basis of Chinese legal philosophy and culture, as it shapes the current culture and unique legal framework that exists in China today. The chapter provides a review of the first attempts to create an insolvency system in the early part of the twentieth century and the failures that were encountered. For example, the bankruptcy law created in 1986 and the problems it encountered are analysed. Various regulatory changes throughout the 1990s are also discussed. The chapter provides an

5 International best practice in bankruptcy law is a term that is commonly used by practitioners and academics when looking at bankruptcy laws and regulations. Looking to developed bankruptcy laws such as the United States, England and the European Union provide a standard for what is ‘best’. Additional international standards such as the 1997 UNCITRAL Model Law on Cross-Border Insolvencies and the 2000 European Regulations on Insolvency Proceedings have created a convergence of accepted principles across the globe, featuring facilitated cooperation in dealing with cases. There is a common theme in dealings in international business to use a high standard of law. The certainty provided by these laws and jurisdictions is necessary for the functioning of international business.
examination of the reasoning behind the introduction of the new bankruptcy law, its multiple drafting stages, and problems encountered during the twelve-year process.  

Chapter 3 discusses the 2006 EBL and its legal characteristics in theory and practice. The chapter includes an overview of the scope of application that the EBL affords to enterprises and a discussion of its application to different business structures. A discussion of the administrators’ role in proceedings — including how these persons are appointed, their qualifications, selection procedures and remuneration — provides an understanding of how their role is governed under the EBL. An analysis of issues regarding workers’ rights, secured creditors, ordinary creditors and the application of security over these interests is also provided. Most notably, the chapter includes a review of the new corporate restructuring provisions the EBL provides for a Western style debtor-in-possession corporate rehabilitation. Finally, Chapter 3 discusses the application and acceptance of cross-border insolvencies and the recognition of both in-bound and out-bound foreign proceedings.

Chapter 4 comprises several studies of recent cases under the old and new EBL. These case studies provide an understanding of how the law is applied in China. They also highlight continuing problems.

Chapters 5 and 6 analyse various issues and problems with the EBL. Research for these chapters was conducted primarily through confidential personal discussions with Chinese, Hong Kong and other foreign-based academics, lawyers, accountants and restructuring professionals. Chapter 5 specifically looks at ‘endogenous’ or ‘systemic’

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6 Enterprise Bankruptcy Law of the Peoples Republic of China, which was adopted at the 23rd meeting of the Standing Committee of the 10th National People's Congress of the People's Republic of China on August 27, 2006, and came into force as of June 1, 2007, herein after referred to as the 2006 EBL.
issues. It discusses seven problems with wider aspects of Chinese law or unique business problems commonly found in China as they relate to bankruptcy proceedings. Chapter 6 discusses problems specific to the EBL. Ten problems are analysed. Some solutions are provided together with suggestions for regulatory reforms.

Chapter 7 concludes the thesis. It contends that the 2006 EBL does not adequately protect foreign creditors.
2. THE HISTORY AND DEVELOPMENT OF CHINESE BANKRUPTCY LAW

2.1 History and Development of Bankruptcy Law

It is generally agreed that the term ‘bankruptcy’ derives from the Italian word *banco rotto* (broken bench). However, the earliest forms of bankruptcy can be traced back to the Roman and Greek civilisations. The earliest code in Roman Laws, the Twelve Tables of around 450 BC, dealt with debtors unable to pay their debts. When the creditor remained unpaid for 30 days, the debtor was placed in private bondage to the creditor. If the debt remained unpaid for a further 60 days, the creditor was entitled to put the debtor to death (*partis secant*, cut into pieces) or sell him or her into slavery.

In the United Kingdom (UK), the first company bankruptcy laws date back to 1844 when Parliament enacted the *Joint Stock Companies Act 1844*, the first legislation to form companies as a distinct legal entity. Prior to this, a company could only be incorporated by charter from the crown or a special Act of Parliament, which might leave the directors of the company liable for its debts. Most common law jurisdictions followed the UK model. Since 1844, however, there have been many revisions and new legislation in the various common law regimes, a discussion of which would be too complex for the purposes of this thesis. The key point is that all ‘Anglo-American’ insolvency regimes have a common ancestry and have developed in parallel.

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9 Ibid, 9.
2.2 The History of Chinese Bankruptcy Law

2.2.1 Historical and Cultural Development

Bankruptcy law in China is a relatively new concept. Traditionally, it was based on the strong belief that ‘a debt must be paid’ and that a ‘father’s debt must be paid by his sons’.\(^\text{11}\) The western notion of bankruptcy to discharge debt does not conform to these traditional values.\(^\text{12}\)

In the Tang (618-907AD) and Song (960-1279 AD) dynasties, there were codes with criminal sanctions for those who defaulted on their debts. There were provisions for debtors in bamboo trading who ‘broke contracts and failed to repay money’.\(^\text{13}\) This was similar to British law regarding bankrupts. Sections 34 and 35 of Henry 8, c. 4, of 1543 was entitled ‘an act against such persons as do make bankrupt’.\(^\text{14}\) It applied to traders and private individuals, but treated bankrupts as criminals, and provided for punishment of the bankrupt via summary execution upon his or her assets. By the eighteenth century, this practice had changed.\(^\text{15}\)

In the Qing Dynasty (1644 - 1911), Book VI of the Fiscal Laws contained an article that provided that if the debtor did not fulfil his or her agreement with the creditor, both in respect to the repayment of the principal, and the payment of the lawful interest, he or she was liable to punishment according to the following scale:

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\(^{13}\) Thomas Mitrano, The Chinese Bankruptcy Law of 1906 - 1907: A Legislative Case History (1973) 263.

\(^{14}\) Ibid.

\(^{15}\) Ibid, 259.
1) Three months after the stipulated period, if the debtor falls short of the amount due to the creditor by five leang or upwards, the debtor shall be liable to a punishment of ten blows, and to an increase of punishment at the rate of one degree for every additional month of delay, as far as 40 blows; 2) Three months after the stipulated period, if the debtor falls short of the amount due to the creditor by fifty leang or upwards, the debtor shall be liable to a punishment of 20 blows, and to an increase of punishment at the rate of one degree for every additional month of delay, as far as 50 blows; 3) Three months after the stipulated period, if the debtor falls short of the amount due to the creditor by 100 leang or upwards, the debtor shall be liable to a punishment of 30 blows, and to an increase of punishment at the rate of one degree for every additional month of delay, as far as 60 blows. In this case as well as the proceeding cases, the debtor shall continue to be responsible for the principal and interest lawfully due.16

The motives for this type of punishment were based on the premise that these crimes constituted civil disobedience as conduct against social norms and behaviour. One early commentator on Chinese law, H.B. Morse, noted:

If a debtor’s own estate will not suffice to pay his debts, the deficiency must be made good by his father, brothers, or uncles; if a debtor absconds, his immediate family are promptly imprisoned; if the debtor returns, he is put in prison and kept there indefinitely, so long as he can find money for his daily food, until released by payment in full, or by death: this is the law.17

As trade developed with China in the nineteenth century, foreign powers needed a system to protect their rights with regards to the repayment of debts. The treaty of Tientsin in 1858 between China and England provided that:

Article XXII – Should any Chinese subject fail to discharge debts incurred to a British subject, or should he fraudulently abscond, the Chinese authorities will do their utmost to effect his arrest, and enforce recovery of the debt. The British authorities will likewise do their utmost to bring to justice any British subject fraudulently absconding or failing to discharge debts incurred by him to a Chinese subject.18

16 Ibid, 264.
This became a tool used by Western merchants against their Chinese trading partners as a device for not paying debts owed to the Chinese.19

Legal reform was desperately required by the end of the 19th century. On 11 March 1902, an Imperial edict was sent out to the Chinese diplomatic representatives abroad asking them to send home copies of texts, treaties and foreign laws.20 On 5 September 1902, England and China signed an additional Treaty, Article XII of which stated that ‘China had expressed a strong desire to reform her judicial system and to bring it into accord with that of the Western nations’.21 This was in exchange for Great Britain relinquishing her extra-territorial rights over China when it was satisfied with the state of Chinese laws.22 There were also additional similar agreements with the US23 and Japan.24 In September 1903, regulations were passed describing the establishment of the Ministry of Trade, and later on 7 December an Imperial Edict proclaimed the Ministry’s existence.25 The first reforms were directed at the criminal law.26 However, the first authorised and promulgated codes were laws dealing with mining and commerce. In 1906, a bankruptcy law was enacted.27

19 Ibid.
22 John MacMurray, Treaties and Agreements with and concerning China (1921) 1, cited in William Frederick Mayers, Treaties between the Empire of China and Foreigners (1966).
26 M.J. Meijer, The Introduction of Modern Criminal Law in China (1949) 17.
2.2.2 The Bankruptcy Law of 1906

On 25 April 1906, the ailing Qing Empire promulgated a modern bankruptcy law known as ‘Pochan Lu’. A mere nineteen months and 23 days later on 2 December 1907, it was repealed, having never been used. This was not uncommon in the early formations of bankruptcy laws throughout the nineteenth and twentieth centuries. The US enacted its first such law on 4 April 1800 and was repealed on 19 December 1803, and the second was passed on 19 April 1841 and repealed nineteen months later on 3 March 1843 by the very same congress that enacted it. The Chinese drafters based the majority of their bankruptcy law, as well as other modern commercial legislation, on British and American law. There was also a reliance on non-Chinese advisors. Edgar Pierce Allen, a Chinese-born, US-educated lawyer, was cited as the document’s foreign advisor.

During the period of its implementation of the 1906 Bankruptcy law, there was a growing conflict surrounding the drafting of the new Criminal and Civil Procedure laws. The Ministry of Trade’s responsibility was to protect trade; however, the bankruptcy legislation also applies to private individuals. Chapter 3 Section 9 of the 1906 Bankruptcy law was entitled ‘Discounting Debts and Bankruptcy’. Of its 23 articles, several are word-for-word copies of the 1906 Bankruptcy Law. Such repetition resulted in confusion, competing interests and inter-Ministry problems. “The question remains even with these attempts to provide China with a bankruptcy procedure, did the

30 Ibid, 259.
31 Ibid, 273.
33 Ibid, 278.
legislators have an idea of what they wanted to accomplish and how they wanted to accomplish it? The answer seems to be no.”

There was a section in the 1906 Bankruptcy law itself that was inconsistent with existing legislation and resulted in its repeal in 1907. Article XL read as follows:

> In the event a merchant’s bankruptcy involved government or public funds, the local authorities, besides allowing the government to receive a dividend *pari passu* with other creditors, shall investigate the matter, and if they shall find it to have occurred intentionally, they shall punish the bankrupt severely according to the fraudulent bankruptcy statute.

The critical clause was one calling for the government to be treated *pari passu* with other general creditors. Official policy was that upon division of a liquidated estate, the debtor was to repay foreign public debts (indemnities) first, government public debts second, and foreign and domestic commercial debts last. This provision resulted in the reordering of the priorities as between Chinese government and its domestic creditors, resulting in the government losing its right to assets it previously possessed.

In December of 1907, the Ministry of Finance sent a communiqué to the Committee for Revising and Compiling Civil and Criminal Codes outlining the problems of competing interests with the Bankruptcy Law and the draft Criminal and Civil Procedure Law. Since no province had put the laws into effect and due to the potential bombshell of Article XL, it was recommended that the bankruptcy law be repealed. Shortly afterwards,

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34 Ibid.
an Imperial rescript authorised the request, and the bankruptcy law was immediately repealed.\textsuperscript{36}

One additional key failure in the implementation of the 1906 Bankruptcy Law was lack of understanding of the law. There was no education or infrastructure provided for government officials as to how to deal with a bankruptcy proceeding. It seems that the reformers of the time were not properly equipped to deal with the complex issues of bankruptcy.\textsuperscript{37}

The conclusion is that the Bankruptcy Law of 1906 was ineffective and not enforced. In addition, it was only many years after its repeal that the extraterritorial powers relinquished their rights in China. To this extent, at least, the law was a failure. More difficult to assess, however, is the value of this legislative experience as a necessary stage in China’s legal modernisation process.\textsuperscript{38}

\textbf{2.2.3 The 1909-1949 Period}

During the early Republic period from 1911-1916, there was a systematic attempt to compile a handbook of regional customary practices to aid judicial and administrative officials.\textsuperscript{39} This \textit{Great Collection of Chinese Customary Civil Practices} contained 42 entries under the heading ‘Customs Relating to Repayment of Debt’. The guide provided many refinancing techniques but did not have the modern concept of discharge. For example, a 1909 legal instrument provided that creditors would accept 50 cents on the dollar in total and final satisfaction of all outstanding liabilities for the debts of a trader

\textsuperscript{36} Thomas Mitrano, The Chinese Bankruptcy Law of 1906 - 1907: A Legislative Case History (1973) 278.
\textsuperscript{37} Ibid, 277.
\textsuperscript{38} Ibid, 295.
\textsuperscript{39} Ibid, 265.
who had fled to parts unknown. The creditors would not be allowed to seek further payment beyond the 50 per cent; however, they had the ability to collect the remaining amount due if the debtor’s whereabouts became known.  

Even without a bankruptcy law in place, there was a desire to have a mechanism to deal with a bankrupt. In 1914, the Chinese Supreme Court (of the Republic) stated that because the bankruptcy law had been repealed, and because it had not been revived, ‘it would naturally be difficult to cite it again’. Nevertheless, later that same year, the Court expanded its interpretation of what was valid bankruptcy practice, stating:

Methods for dealing with bankruptcies that may be recognized as consistent with general principles of bankruptcy law may still be had recourse to by parties. Such methods may not be turned down merely because our nation at present has no legal provision for bankruptcy.

In 1915, the Peking Law Investigation and Review Board proposed a draft bankruptcy law. It was divided into three sections: substantive, procedural law and sanctions. It totalled 337 articles, and was modelled on the German example. On 18 November 1926, permission was granted by the old Ministry of Justice and Government Administration for the law to go into effect temporarily. However, shortly after the Nationalist Government enacted it, it passed into disuse once again.

The Nationalist Government passed a bankruptcy law on 17 July 1935 and implemented it on 1 May 1937. It is interesting to note that the different laws and drafts during this

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40 Ibid.
42 Ibid.
period created the basic structure of the bankruptcy law of Taiwan.\textsuperscript{46} This was a judicially managed process with a high degree of court oversight of the bankruptcy proceeding. The law was directed at individual traders, but also extended to companies, partnerships and deceased debtors.\textsuperscript{47}

\textbf{2.2.4 The Mao Era 1949-1976}

In October 1949, the Communist Party of China came to power in the newly founded People’s Republic of China (PRC) and a new country was born. On 14 January 1949, Mao Zedong announced an intention to abolish all current laws including the 1935 Bankruptcy Law, and the formation and promulgation of a new constitution by a new Political Consultative Conference and Democratic Coalition Government.\textsuperscript{48} All laws enacted by the Republic of China were abolished and the PRC set forth to develop a new socialist legal system. The Ministry of Justice was formed, and law schools and law journals began to appear.\textsuperscript{49}

Mao and the Socialist government had an ideological concept of the Iron Rice Bowl in which the concepts of bankruptcy were foreign. ‘Iron Rice Bowl’ was a term that referred to an occupation with guaranteed job security, steady income and social benefits.\textsuperscript{50}

As part of the sweeping changes in 1949, a declaration was made that gave Chinese officials the power to close, suspend, merge or transform an under-performing enterprise.

\textsuperscript{46} Z. Yu, Systems and Legal Practice of Bankruptcy Law (1999) 5.
\textsuperscript{49} Randall Peerenboom, China's Long March toward the Rule of Law (2002) 44.
Under these orders the state was now responsible for all debts and find new jobs for workers.

Consequently, many managers and directors of failed enterprises were not only relocated, but periodically promoted as a result of the closure, merger or transformation. Governmental control was at the heart of this procedural absurdity since it was their organs which were charged with the authority to establish and close SOEs and not the People’s Court.51

In October 1955, the Supreme People’s Court and the Ministry of Justice issued a response on how to deal with unpaid debts by private enterprises at the time: the ‘Reply on Two Issues Concerning the Procedures for Repayment of Debts by Bankrupt Private Enterprises’ and, later in 1957, the ‘Reply on Several Issues Concerning Bankruptcy Liquidation.’52 This provided the framework for the final nationalisation of all assets. Soon after this, the socialist transformation was declared complete and private enterprises largely ceased to exist.53 In principle, there is no need for bankruptcy law in a socialist planned economy. The transfer of funds and supply of materials between enterprises in the PRC were not conducted on the basis of credits and debts; they were adjusted in accordance with state plans.54 For the next 30 years, the PRC did not have and did not need a bankruptcy law under its planned socialist economy.

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53 Ibid.
2.3 Development of Commercial Bankruptcy Law

2.3.1 Early Developments

Shortly after the death of Mao in 1976, China began its economic reforms and opened the doors for policy reform and changes in the legal system. The first concepts of debt repayment appeared in Chapter 17 of the 1982 Civil Procedure Law (For Trial Implementation) which provided that:

Article 180: If the Property of the person against whom a judgment or order is being executed is not enough to meet all the claims, he shall pay off his debts in the following order:

1. Wages and living expenses;
2. State taxes;
3. Loans from state banks or credit cooperatives; and
4. Other debts.

If his property is not enough to pay all the claims that belong to the same category, it shall be divided proportionally among those claimants.

This was the first time in any PRC legislation that some of the concepts of bankruptcy were used without mentioning the word ‘bankruptcy’ anywhere in the legislation.

In the early 1980s, the Chinese scholar, Cao Siyuan, was the first person to suggest that a Bankruptcy Law was required. He wrote that, ‘maybe I was the first person to come up the idea of having a bankruptcy law, but for many more people, subconsciously perhaps, the need for a bankruptcy law has already emerged’. One of the benefits of the socialist system was that ‘socialist enterprises will never go bankrupt’.

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58 Ibid.
ought to be declared bankrupt were never declared bankrupt. Instead, the state treasury siphoned funds from the ‘fat’ ones to give to the ‘lean’ ones, and in the process kept up a state of universal impoverishment that became more serious with each passing day.\textsuperscript{59}

In early 1983, the then Premier Zhao Ziyang assigned responsibility to the State Council Technology and Economic Research Centre for drafting a document for the purpose of economic development. “It was passed down through the organization and lands on my la,” Cao Siyuan wrote. “It was an opportunity of a lifetime, and I was resolved to stick in my own piece of contraband – that is, the bankruptcy law”.\textsuperscript{60} It was put forth as a working document at the National Conference on Technological Work and was well received. Premier Zhao responded with the instructions that the Office of the Technology Leadership Group and Technology and Economic Research Centre organise the document into an official document that would be submitted to the State Council for review and approval.\textsuperscript{61}

Regarding the drafting of the law, Cao Siyuan completed the first draft of the ‘Regulations for Bankruptcy and Reorganization on Enterprises (Draft Plan)’ on 13 August 1984. Another five drafts were made and by 28 October 1984, the ‘Report Requesting Directives for Drafting the ‘Law of Bankruptcy and Reorganization of Enterprises’ was issued to the State Council Economic Laws and Regulations Research Centre. On 10 January 1985, the EBL drafting group was founded of which Cao Siyuan was a member and later became the head of the drafting team. The first draft was approved by the State Council and sent to the Standing Committee of the National People’s Congress (SCNPC) for its deliberation. There was massive opposition and the

\textsuperscript{59} Ibid.  
\textsuperscript{60} Ibid.  
\textsuperscript{61} Ibid.
draft was opposed 41 to nine. A year of discussions and a reduction and editing of the legislation from 11,000 to 4,800 words took place. On 2 December 1986, the Law on Enterprise Bankruptcy (Trial Implementation) was finally adopted by the SCNPC. This was a significant milestone since this was a key piece of legislation signalling the transition from a socialist planned economy to a market-oriented economy.62

2.3.2 Experimental Legislation to the Lead Up of the 1986 Bankruptcy Law

The first mention of the word ‘bankruptcy’ first appeared in the PRC in a municipal law rather than in national regulations. Introduced by the Shenyang City Municipal Government on 9 February 1985, these regulations were known as ‘Trial Regulations Regarding the Handling of the Bankruptcy and Closing Down of Industries and Enterprises under the Collective System of Ownership’ (the ‘Daobifa’ or ‘Closing-Down Regulations’).63 This was part of the experiment that Cao Siyuan started to carry out, as it was necessary to see how it would be received on a small, controlled basis.64 These regulations were made in response to a pressing need for a way to deal with insolvent SOEs within the city. The local authority apparently could not wait for the enactment of a national law. It implemented ‘trial measures’ to deal with several enterprises that were effectively bankrupt. The local People’s Court declined to be involved with this experimental legislation, as it doubted the local authority’s power to enact such laws. It became more of a guideline for the administrative handling of bankruptcy cases through the local industrial and commercial bureaus. Using a balance sheet test of its debts exceeding its assets for a period of two years, a business would be considered having ‘reached the line of bankruptcy’. When it reached this point, it had one year to become

64 Ibid.
solvent; this was known as receiving a ‘yellow card’. The local industrial and commercial bureau arranged meetings with the management of the enterprise. A special supervisory committee was appointed to investigate and oversee the enterprise. There was also the establishment of a ‘bankruptcy fund’ that provided living allowances for employees of the bankrupt enterprise. Several State-Owned Enterprises (SOEs) were on the road to financial recovery in as little as five months.

Similar experimental legislation was introduced in Wuhan in June 1985 where the first experimental bankruptcy would be conducted on the No. 3 Radio Factory of Wuhan municipality. On 21 June 1985, the decision was made to make it the first state-run enterprise in Mainland China to undergo experimentation with a system of bankruptcy. The factory was given its ‘yellow card’ one-year warning to reorganise itself and turn around the business. It was able to change its focus and instead of producing radios, it developed construction-related electronics and electrical products. However, it did produce a children’s radio on a small-scale production for Children’s Day, which sold very well. After the one-year period, leadership at the factory came to understand that ‘the decision that the municipal government in declaring our factory on the brink of bankruptcy and giving us a deadline to reorganize ourselves and turn things around was a good decision. Without this pressure, and without being forced, this factory would not have been able to be rejuvenated’.

On 3 August 1986, there was a turn of events in Shenyang. Exactly one year earlier, the municipal government issued the Shenyang Municipal Explosion-Prevention Device

65 Ibid.
68 Ibid.
69 Ibid.
Factory with a ‘yellow card’; however, it was not able to turn around ten years of consecutive losses. The factory was declared on that day to be bankrupt and closed for business. Its operating license was confiscated and its bank accounts revoked. This news spread quickly throughout the county and was even reported in the news in Japan and France, where the news agency *Agency France-Presse* sent a telegram stating ‘this is the biggest step towards breaking the “big pot of rice” syndrome that has been taken in China since the founding of the People’s Republic’.  

2.3.3 The 1986 Enterprise Bankruptcy Law

On 2 December 1986, the EBL (For Trial Implementation) was introduced after repeated discussions of the NPC Standing Committee by a vote of 101 in favour, zero against and nine abstentions. It did not immediately take effect as Article 43 provided that the law would only be implemented three months after the introduction of a yet to be enacted Law on State Industrial Enterprises. This later law was not enacted until 13 April 1988, taking effect on 1 August 1988, thus giving the 1986 EBL an effective date of 1 November 1988, almost two years after being passed by the National People’s Congress. The final enacted law comprised of 43 articles and 5,400 words.

Like many other areas of law in China, the insolvency regime has been seen by some to be ‘like an onion,’ with many different layers of different laws applicable to different

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70 Ibid.
71 Ibid.
74 Ibid.
types of companies and situations. Implementation was achieved on an *ad hoc* basis on many different levels.

The insolvency regime can now be divided into various categories, as follows: national legislation; opinions of the Supreme People’s Court; specific national legislation dealing with particular types of insolvency (i.e. a bank or foreign investment vehicle), and, regional insolvency regimes.

### 2.3.4 Problems with the 1986 Law and the Development of a Unified Law

After the emergence of the 1986 Bankruptcy Law and the numerous additional regulations that were introduced to implement different cases, it became necessary to review the current bankruptcy regime and develop a new law that was more

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comprehensive. In March 1994, the Standing Committee of the 8th National People’s Congress, Fiscal and Economic Committee appointed the organising individuals to draft a new bankruptcy law.\textsuperscript{77} In the autumn of 1995, the Draft Bankruptcy Law (‘the 1995 draft’) consisting of ten chapters and 193 articles was released. It was proposed to the authorities and was subsequently shelved for four years.\textsuperscript{78} In the formation of the 1995 draft, there were three different scopes of applications proposed: 1) Small Scope: The law should be applied to enterprise legal persons including SEOs; 2) Medium Scope: The law should include enterprise legal persons, partnerships enterprises with partners, sole proprietorships with their investors; and 3) Large Scope: The law should be applied to all types of enterprises, legal persons or non-legal persons and all natural persons.\textsuperscript{79} Ultimately, the medium scope was chosen, as there were numerous issues surrounding the concepts of introducing a process for individual bankruptcy as the large scope would have dictated.

There is some historical significance to the concept that people are required to pay their debts and these debts are carried forward from one generation to the next, as discussed in a previous section of this thesis. Chinese society also has the attitude of ‘saving the future’ instead of ‘overdrawing the future’ so that the concept of consumer insolvency is not as important as in consumer credit driven economies.\textsuperscript{80} There were a number of reasons why individual bankruptcy legislation was never enacted. China’s economy is in transition, and a great number of ordinary citizens are not solvent and able to pay their debts. Individual bankruptcy law would create complex social problems, as the shame of bankruptcy would be harmful to the social fabric. Finally, the capacity of the judicial

\textsuperscript{78} Ibid.
\textsuperscript{79} Ibid.
\textsuperscript{80} Ibid, 2.
system and professional services would be insufficient to deal with the large number of claims and there would be a backlog in the courts that would stifle the entire system. These questions have arisen since the early discussions on the implementation of an individual bankruptcy law. This is discussed further in sections 3.2.3 and 6.1.10.

Regarding the ‘small scope’ that was supported by some officials and judges, there were concerns with the application and difficulty on technical matters for the treatment of non-legal person enterprises to be included within the scope. This class of enterprises accounted for approximately half of the enterprises within the country. It was decided that it would be unfair not to include them within the regime, as it would not meet the requirements of equal treatment and unified regulations in a market economy. The medium scope was chosen in the proposed 1995 draft as it met the requirements of a socialist market economy, in which all the businesspersons and commercial debts can be regulated uniformly and equally. This was also categorised within the traditional ‘merchant bankruptcy’ systems that have been seen in French and Italian bankruptcy regimes.

The 1995 draft was presented to the relevant authorities and then was shelved for a four-year period during the late 1990s. In March 2000, the drafting committee was called back to work, a new schedule was established and ‘the Business Bankruptcy and Reorganization Law’ drafts were created mostly by dusting off the 1995 draft. One of the drafters, Wang Weiguo wrote:

During the four-year rest period of drafting work, there were some significant events that might be influential upon our further efforts, e.g. the deepening of SOE reform, China’s entering the WTO, the Asian

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81 Ibid.
82 Ibid.
83 Ibid.
financial storm, and the new achievements of overseas and domestic researches on bankruptcy law. When reviewing the 1995 draft today, we realize that there are a number of issues that are still disputable or need to be reconsidered under the circumstances of the new experience and achievements. \(^\text{84}\)

2.3.5 Issues Arising During the Drafting of the 2006 EBL

Various issues that have emerged since the implementation of the 1986 Bankruptcy Law are addressed in an article by Professor Li Shuguang, an expert advisor on Chinese bankruptcy law to the World Bank and the Asian Development Bank who participated in the drafting of the New Bankruptcy Laws. \(^\text{85}\) These issues created problems for the drafting committees. Numerous drafts resulted in delays of the enactment of the new 2006 EBL. Professor Li’s recommendations and comments regarding the drafting process of the new EBL may be summarised as follows:

1. **The Government’s role in bankruptcies.** The government has had a multi-faceted control of the bankruptcies of SOEs. Government made the policy, initiated the proceedings, lent the money and operate it. It controls the number, scale and speed on the process, but also controls what industries and trades are covered under the law. In contrast, the government does not have influence over non-SOEs as government is not the legal owner of the enterprise. \(^\text{86}\)

2. **The Courts role in bankruptcies.** Since the government appoints the judges and allocates the budget for the local Court’s, these Court’s are not independent. The old law

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\(^{84}\) Ibid, 1.


\(^{86}\) Ibid, 6.
did not have any specific previsions as to which level of Court was to hear the case. There is a lack of experience in dealing with these cases as there was never a bankruptcy case prior to the implementation of the law in 1988. The judges had little knowledge on the subject and have been reluctant to accept cases.  

3. **Who is the real debtor?** There was problem in identifying the ‘real debtor’. An SOE is technically ‘owned by the whole people’ but it was unclear as to who represents the state in exercising its authority to grant approval and make the decisions for an enterprise facing bankruptcy. SOEs were also owned directly by multiple governments at the local and national levels. These different governments were quick to evade their responsibilities and ‘pass the buck’ to someone else. Many SOEs have complex structures of parent companies and subsidiaries, which add to the complexity. These SOEs are not independent legal persons, thus issues of joint liability for debts arose from this structure. The absence of clear legal relationships made it easier for parent companies to evade their liability.  

4. **The Anti-bankruptcy Stance of Creditors.** Creditors of the bankrupt SOE were the last to be paid under the current 1986 EBL. Employees were paid first and then bank creditors have priority over non-bank creditors. As there was often little money left after settling with the employees and state-owned banks, this class of creditors is usually hit very hard and they are opposed to the bankruptcy of the enterprise.  

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87 Ibid.
88 Ibid, 7.
89 Ibid.
5. Difficulties in Laying Off and Settling Employees Claims. Settling or laying off employees was an extremely difficult process. The SOE employees were reluctant to accept redundancy as it went against the tradition that a state employee is guaranteed an ‘Iron Rice Bowl,’ or lifetime employment. Moreover, if they were laid off, these employees become a source of social instability as the Local Government had to provide for that employee and the amount of funding for social programs may be insignificant. Further, how to settle the employees’ claims as where the settlement monies come from and who was to be responsible for the liability. Lastly, the legal rights of the employees and the bankrupt are not adequately protected due to the lack of contractual enforcement.\footnote{Ibid, 8.}

6. Lack of professional intermediary service organisations involved in bankruptcy cases. The scarcity of professional services, such as law and accounting firms lack of necessary knowledge in commencing and running the proceedings, resulted in a low efficiency of work and a higher cost for the work. Only a few firms had this experience. It is also important to note that there was no trustee system for handling bankruptcies.\footnote{Ibid.}

7. Inadequacy of Bankruptcy Law and Policies. Owing to complex economic realities in China and how the bankruptcy law had been developed, the procedures were vague and those governing non-SOE bankruptcies were deficient. There was no legal basis for the filing of a bankruptcy of a natural person, partnership or corporation. In addition, there was no reorganisation procedure for insolvent enterprises; there are numerous\footnote{Ibid.}
conflicts and inconsistencies between the bankruptcy law and the then existing
government policies.  

8. Fake Bankruptcy Cases. Enterprises had been known to evade their liabilities by
declaring bankruptcy after splitting off the profitable part of the business into another
entity and changing licenses. Asset shifting and debt repudiation by taking advantage of
the bankruptcy procedures were a problem.

9. Confusing Guarantee Relations. Enterprises were been known to give guarantees to
each other, resulting in duplicate pledges of the same asset. These types of guarantees
create a circularity problem that lead to a chain reaction of bankruptcies.

10. Difficulty of Evaluating Creditors’ Rights and Liabilities. Li stated that ‘there was
often a discrepancy between the appraisal value of bankruptcy property and its market
value’. Government officials determined property values. They do not necessarily
reflect true value. Independent market valuations were needed to obtain a correct
valuation.

11. Bankruptcy concerning enterprises with foreign participation. The large amount
of Sino-foreign Joint Ventures (JVs) created problems. In most JVs, it was unclear who
bears the responsibility after a bankruptcy. The 1986 Bankruptcy Law dis not supply

92 Ibid.
93 Ibid.
94 Ibid, 9.
95 Ibid.
sufficient protection for foreign investors making China a less attractive investment option.\textsuperscript{96}

\section*{2.4 Number of Bankruptcy Cases}

There have been 73,179 bankruptcy cases in China from 1989 to 2008. Even though the 1986 EBL was implemented in 1986, there were no reported cases for statistical analysis until 1989. As can be seen in Figure 1, during the first five years from 1990 to 1993, there were a few cases, and then in 1994 when additional regulations regarding bankruptcy were put in place, there was a sharp increase in the number of cases. Between 1995 and 2004, there were many SOE restructurings resulting in the majority of all bankruptcy proceedings. Since 2004, there has been a drop to approximately 3,000 cases a year, and there has been no real change in the number of cases since mid-2007 when the 2006 EBL became effective.

\textsuperscript{96} Ibid,10.
2.5 Rule of Law in China

It is important to note that conceptions of the rule of law in China differ from common law jurisdictions. The topic is vast and cannot be covered in this thesis. (For example,

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Footnotes:

a discussion of judicial independence in China is an entire thesis in itself.) Nonetheless, the following general observations can be made.

The movement to a market based economy in China created the need for legal reforms. The success of these reforms and the ability to attract foreign investment into China hinges upon improvements to the legal system. “A market economy is a rule of law economy.”99 It can be said that the rapid development of commercial law in China has arisen from economic need.

There are different theories as to the development of the rule of law. Peerenboom, for example, developed a system of classifying the rule of law into thin and thick versions that has a set of criteria that differentiates countries at different stages of development.100 Peerenboom believes that China has moved away from a purely instrumental conception of law towards a conception of a rule of law which is intended to bind both government officials and citizens, though he concedes this goal is not often realized in practice in China.101

Jianfu Chen states that what is important is the substance and not the label. In his research, Chen says that it is understood by the people that “there must be laws for people to follow, these laws must be observed, their enforcement must be strict, and law-breakers must be dealt with”.102 This approach contains the assessment criterion that has been held by the Chinese Communist Party and government officials to be the essence of the rule of law. The questions that have to be asked are “according to whose law, to

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100 See generally Peerenboom, Randall, China's Long March toward the Rule of Law (2002).
102 Ibid
whom are the laws applied, and how are they applied.”¹⁰³ This seems to be the current trend of development of law in China.

2.6 Chapter Conclusions

This chapter provides the background for the historical development of bankruptcy law, development of the first EBL in 1986, a discussion on the various reasoning’s for the new 2006 EBL and a review of rule of law in China. Chapter 3 will discuss the implementation and analysis of the 2006 EBL.

¹⁰³ Ibid.
3. THE 2006 ENTERPRISE BANKRUPTCY LAW

3.1 The Implementation of the 2006 Enterprise Bankruptcy Law

Regarding the implementation of the 2006 EBL, Professor Charles Booth, a leading academic expert on insolvency law states:

A key goal of the insolvency law reform was to harmonize the various processes in China and to enact a unified law that would replace the old patchwork of insolvency legislation. This goal has been achieved to a great extent. Article 2 of the 2006 PRC EBL provides that the new bankruptcy law applies to all enterprises with legal person status. Thus, the insolvency regime has been dramatically simplified.104

The 2006 EBL was a monumental achievement in the development of a modern insolvency regime as it replaced the outdated 1986 PRC Bankruptcy Law and various regulations. The revised PRC Civil Procedure Law, which came into effect on 1 April 2008, has had all of its insolvency provisions removed in Chapter XIX.105 In addition, Article 191 of the amended PRC Company Law106 provides ‘that if a company is declared bankrupt in accordance to the law, it shall be subject to the liquidation in accordance with the new 2006 EBL’.107

The implementation and passing of the law by the Standing Committee of the National People’s Congress was a milestone that took place on 27 August 2006 with 157 members voting for, two voting against and two abstaining.108 The process was greatly lengthened in time because the leadership within the National People’s Congress had to be educated

105 2007 Civil Procedure Law (Revised).
106 2005 Company Law (Amended).
as to the value of a bankruptcy regime and the benefits it would provide to the development of a market-based economy. Jingxia Shi notes:

The formation of the 2006 EBL combines international experience with Chinese characteristics to address practical demands. Over the last decade in particular, many multilateral bodies such as the Asian Development Bank (ADB), the World Bank, International Monetary Fund (IMF), OECD, United Nations Committee on International Trade Law (UNCITRAL), and practitioner communities like INSOL International have developed the international standards of best bankruptcy practices.  

The drafters of the law drew on these international resources and expertise, while taking a ‘Made in China’ approach that did not directly transplant a foreign insolvency regime. This resulted in a law that was thought to be appropriate for market conditions and still met the goals of the state in protecting its interests and that of its citizens. Like most modern legislation in China, it is indigenous in terms of structure, emphasis and approach. Its conceptual universe has been described as being ‘essentially framed’ by the insolvency systems of Germany, Australia and the US:

Germany, because it is a civil law country, the progenitor of some earlier East Asian legal systems, and a country that emphasizes the rights and influence of banks in corporate reorganization; Australia, because it is a common law system that emphasizes the voluntary nature of bankruptcy and has strong provisions for employees; and the United States, because it is a common law system that emphasizes the

109 Ibid.
110 The UNCITRAL Legislative Guide sets out nine key objectives of insolvency law: 1) the provision of certainty in the market to promote economic stability and growth; 2) the maximization of the value of assets; 3) striking a balance between liquidation and reorganization; 4) ensuring the equitable treatment of similarly situated creditors; 5) provision for timely, efficient and impartial resolution of the insolvency; 6) preservation of the insolvency estate to allow equitable distributions to creditors; 7) ensuring a transparent and predictable insolvency law that contains incentives for gathering and dispensing information; 8) the recognition of existing creditor rights and establishment of clear rules for ranking of priority claims; and 9) the establishment of a framework for cross-border insolvency; See especially, Roman Tomasic, ‘The Conceptual Structure of China’s New Corporate Bankruptcy Law’ in Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds) China’s New Enterprise Bankruptcy Law: Context, Interpretation and Application (2010) 21.
rights of debtors and manages and champions the role of management in corporate reorganization. \[112\]

The new law consists of 136 articles in twelve chapters. It is the most comprehensive insolvency law China has seen to date. The law is a great improvement over the previous law. When the 2006 EBL became effective on 1 June 2007, the 1986 EBL was simultaneously abolished. \[113\]

### 3.2 Scope of Application: Overview

During the drafting process, the development of the law was extremely contentious. As described in the previous chapter, it was a long, drawn-out process over twelve years owing to issues and problems encountered during the previous drafts. When considering the scope of the law and the types of entities it would apply to, it was eventually decided that the 2006 EBL would apply to all legal person enterprises, whether an SOE or non-


SOE.\textsuperscript{114} The law does not apply to non-legal person entities such as partnerships, sole proprietorships and individuals. This issue is further discussed in sections 3.2.4 and 6.1.10. In addition, there are regulations regarding the bankruptcy of financial institutions — mainly banks, insurance and securities companies. All four of these are addressed below.

\subsection{3.2.1 The new law and the State-Owned Enterprises}

The process of bankruptcy for SOEs was first introduced with the 1986 EBL, which provided for the reorganisations of ineffective and defunct State-Owned assets. The Chinese economy was then greatly reliant on SOEs and they were the backbone of economic output for the country. This was the so called “Iron Rice Bowl” that provided employment for life and a social security net that provided benefits such as housing, education and healthcare. The Central Government realised, however, that if the economy was to move to a socialist market economy, there needed to be drastic changes in the landscape of business and an opening-up to globalisation and privately owned enterprises.

It became apparent that the implementation of the 1986 EBL would mean that the broad-based Iron Rice Bowl social policy would have to change. Where an SOE was subjected to bankruptcy or reorganisation, the position of employees had to be addressed. The SOE would no longer be able to provide a lifetime of social benefits and employment.\textsuperscript{115} In 1994, the SPC issued the ‘Notice on Several Issues Concerning the Trial Implementation of State-Owned Enterprises in Several Cities’, which formed the basis

\textsuperscript{114} Article 2, 2006 EBL; See also Haizheng Zhang and Xiaohe Tan, ‘Bankruptcy Petition and Acceptance’ in Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds) China’s New Enterprise Bankruptcy Law: Context, Interpretation and Application (2010) 73, 74-77.

for a ‘planned bankruptcy’ or ‘policy-oriented bankruptcy’.\textsuperscript{116} The process by which a bankruptcy of an SOE was undertaken was planned out by the state and financially subsidised by the local and Central Governments. Workers’ rights were paramount. Dealings with workers and their relocation were important. ‘In effect, a policy-oriented bankruptcy was more like an administrative arrangement than a judicial process and was carried out with considerable caution in order to prevent the possibility of social upheaval.’\textsuperscript{117} Documentation issued by the State Government in 1994, 1997 and 1999, shows that bankruptcies were carefully planned.\textsuperscript{118} There was a requirement for authorisation and approval by the National Bankruptcy Liaison Group, which was organised and directed by the State Council.\textsuperscript{119}

An article within the new 2006 EBL states:

The particular issues concerning the bankruptcy of State-owned enterprises within the scope and time limits specified by the State Council before this law takes effect shall be handled in accordance with the relevant regulations of the State Council.\textsuperscript{120}

This is of particular importance as the EBL applies to all enterprise legal persons and does not make a distinction between SOEs and non-SOEs; however, there are still remaining SOEs that need to be addressed by the regulations prescribed by State Council. The State-Owned Assets Supervision and Administration Commission (SASAC), a commission of the State Council, issued regulations stating that June 2008 would be the deadline in addressing bankruptcies of these select SOEs. By the end of 2007, SASAS

\textsuperscript{118} In 1994 the State issued the Capital Structure Optimisation Programme that was a initial guide for the bankruptcies in select cities. In 1997 the scope of the project was enlarged to 111 cities. 1999 saw the scope expanded to a national level. For details see, ACW Tang, Insolvency in China and Hong Kong: A Practitioners Perspective (2000) 5.80.
\textsuperscript{119} Rebecca Parry and Haizheng Zhang, ‘China’s New Corporate Rescue Laws: Perspectives and Principles’ 8(1) Journal of Corporate Law Studies 113, 117.
\textsuperscript{120} Article 133, 2006 EBL.
had processed 2,116 applications filed to take advantage of the policy-oriented bankruptcies. It was estimated that remaining SOEs would be brought to a close by the end of 2008. SOEs and non-SOEs would have the same treatment as there will be a unification of the laws and they would all be addressed equally.\textsuperscript{121} There remains a ‘last batch of policy bankruptcies’ that consists of 698 SOEs still to be processed by the end of June 2008. It appears that at the time of writing, the goal still has not been met and has been extended again. Booth writes, ‘it seems that whenever SASAS is ‘almost’ done, there are always a few more hundred SOEs in need of administration closure. It is most likely that policy bankruptcies will continue – at a minimum – for many more years to come.’\textsuperscript{122}

3.2.2 Bankruptcy Law and Financial Organisations

The financial health of Chinese banks and financial organisations during the 1990s and early 2000s was poor. The most notable example was the collapse of the second largest trust and investment company, the Guangdong International Trust and Investment Corporation in 1999. This was the largest bankruptcy to date in the PRC; with liabilities totalling US$4.37 billion.\textsuperscript{123}

The 2006 EBL includes financial institutions under the general bankruptcy law. These institutions are subject to the EBL with the application of a supplementary provision, Article 134, which gives the financial regulators authority under the State Council to file an application to the People’s Court for the rectification or bankruptcy liquidation of the

\textsuperscript{123} Angus Francis, ‘Cross-Border Insolvency in East Asia: Formal and Informal Mechanisms and UNCITRAL’s Model Law’ in Roman Tomasic (ed), Insolvency Law in East Asia (2006) 546.
It permits the financial regulatory authority to take custody of and take over the operations of the financial institution. This is designed to allow the regulators to prevent potential increased risks and liabilities where the financial institution or its creditors fail to duly file a bankruptcy application when it meets the requirements under the EBL. By placing it into a trusteeship rather than a direct bankruptcy proceeding, the regulator has a better chance of saving the financial institution and implementing a proper proceeding for rehabilitation or liquidation. This is intended to prohibit litigious creditors seizing the financial institutions assets, and thereby rendering a take-over or trusteeship virtually impossible.

The State Council also reserved the right under the 2006 EBL to formulate ‘implementing measures’, several of which have already been enacted. These regulations provide guidance as to how the State Council wishes the proceedings and method of the bankruptcy to take place. Shi notes that, “a feasible deposit insurance or similar scheme, the prerequisite for bankrupting banks and providing a market-exit mechanism for other financial institutions, should be set up in China in order to ensure that the bankruptcy regime for financial institutions functions effectively in practice”. This is required to ‘minimize the aftermath of bankruptcy of banks and financial

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126 For example see, The Administrative Regulation of Foreign Capital Banks, Article 60 (15 November 2006); The Administrative Regulations of Futures Trading, Article 19 (16 March 2007); Measures of Financial Leasing Company Administration, Article 19 (16 March 2007); Measures of Automobile Financing Company Administration, Article 16 (3 February 2008); and Measures of Trust Company Administration, Article 14 (28 March 2007).
institutions while simultaneously providing the maximum protection to the interests of depositors, creditors and taxpayers’.  

In early 2008, the China Banking Regulatory Commission (CBRC) began to further address the issue and develop regulations. No timeframe for the legislative process is yet available. The sequence of the plan is to firstly implement a deposit insurance plan, then set up a deposit insurance fund and finally incorporate an independent deposit insurance company. The CBRC states that ‘with the opening-up of financial areas, local banks and financial institutions will face fiercer competition. Only by allowing incompetent and highly risky players to withdraw from the market can a country defuse any financial crisis and safeguard domestic financial system [sic].’

3.2.3 Non-Legal Persons Including Partnerships and Sole Proprietorships

As discussed earlier, during the drafting process of the new EBL, there was much debate whether or not to include persons, including partnerships, sole proprietorships and individual entrepreneurs under the definition of a legal person under the blanket of the new bankruptcy laws. In the numerous drafts since 1994, this was one of the open issues that was controversial and was included and then excluded in numerous drafts. The view of the drafting committee was that by declaring these persons bankrupt, partners and individuals would be personally included within the proceedings. ‘Subjecting these individual entrepreneurs to the bankruptcy procedures also enables Courts to obtain

experience in grappling with issues of individual bankruptcies, such as the automatic discharge and property exemptions.¹³² This was removed after the first review of the June 2004 draft, as the drafting committee felt that it was premature to subject individuals to bankruptcy law at this point.¹³³

However, there is a mechanism for the bankruptcy and liquidation of partnerships under current Chinese law. Article 135 of the EBL provides that the liquidation of organisations other than a legal person shall follow the procedures as prescribed by the EBL for liquidation. On the same day the EBL became effective, there was an amendment to the Partnership Enterprise Law, which provided for the insolvent liquidation of partnerships. Article 92 of the Amended PRC Partnership Enterprise Law states:

Where a partnership enterprise is unable to pay off its due debts, the creditors may apply to the People’s Court for bankruptcy liquidation, or may request the common partners to make repayments. Where a partnership enterprise is declared bankrupt, the common partners shall still bear joint and several liabilities for the debts of the partnership enterprise.¹³⁴

This provision enables the creditors of a partnership to apply to the People’s Court for bankruptcy of the partnership. It does not allow the partnership to apply. The proceedings are limited to liquidation or repayment and do not allow for the rehabilitation procedures under the EBL.

Once the proceedings begin, the Court appoints an administrator to begin the management and liquidation of the partnership assets — just as the regular process of liquidation of an enterprise under the EBL would take place. The debtor’s property is now protected by the Courts; creditors are unable to act on security agreements and the

¹³³ Ibid, 659.
distribution of assets occurs in accordance with the creditor’s rights within the remaining distribution of assets *pari passu*.

The combination of Article 92 of the Amended PRC Partnership Enterprise Law and Article 135 of the EBL provides the basic mechanism for liquidation of partnerships; however, there remains unlimited personal liability for the debts of the partnership. This is still an issue and needs to be addressed. Booth writes:

> It is good to see that creditors may resort to filing a petition against a partnership, but it is unfortunate that the right to petition was not extended to partnerships themselves. Similarly, it would have been better if the individual partners and sole proprietorships were also eligible for bankruptcy relief. Subjecting individual business owners and partners to the new bankruptcy law would provide the Courts with experience in addressing some of the issues that arise in individual bankruptcies, such as those involving automatic discharge and exempt property.\(^{135}\)

### 3.2.4 The Bankruptcy Law and Individuals

The EBL does not provide for any bankruptcy proceedings for individuals, nor does any other piece of legislation in the PRC. With the ever-increasing middle and upper class within China and the expansion of consumer credit, such laws will become necessary. Section 6.1.10 of this thesis will advance the proposition that individual bankruptcy law is needed in China.

### 3.3 Bankruptcy Tests and Application

From the introduction of the 1986 EBL until recently, the Chinese Courts, creditors and all parties involved have developed an overly negative attitude towards bankruptcy

procedures. In 1997, at the height of SOE bankruptcies, the average rate of recovery was 6.63 per cent with many cases ending up with zero distribution to creditors.\textsuperscript{136}

Bankruptcy practitioners within China have noted that Courts and many of the parties participating in bankruptcies have developed an overly-negative view of the possible results that may be achieved in bankruptcy, with the result that the insolvency procedures are almost always used to liquidate the assets of an insolvent company rather than applied with a view to reorganize or rehabilitate a company in financial distress.\textsuperscript{137}

In deciding when to initiate a proceeding to rehabilitate the company instead of liquidating it, there need to be tests to define clearly the instances in which commencement of a bankruptcy case can proceed. In any insolvency system, a trigger mechanism is needed to initiate the proceedings. Determining if an enterprise is solvent, means assessing if it has the ability to meet its financial obligations. The definition of bankruptcy is defined in the relevant national legislation. A common law definition of ‘solvent’ and its opposite provides a test of insolvency.\textsuperscript{138} It states that: 1) a person is solvent if, and only if, the person is able to pay all the person’s debts, as and when they become due and payable; and 2) a person who is not solvent is insolvent.

Courts in the West use either cash-flow or balance sheet tests to determine if the company is solvent. Firstly, the cash-flow test states that ‘if it is proved to the satisfaction of the Court that the company is unable to pay its debts as they fall due,’\textsuperscript{139} then the company becomes bankrupt or insolvent at that point. Here, there is insufficient cash or other realisable resources available to pay all creditors at the various times upon which they can demand payment. Second, the balance sheet test holds that a company is

\textsuperscript{136} Li Guoguang, Speech presented at the Second Economic Trial Division of the High People’s Court of Jilin Province 1 April 1998.
\textsuperscript{139} Insolvency Act UK (1986) s.123(l)(e).
bankrupt or insolvent if the total liabilities outweigh the value of the assets and there are insufficient assets to discharge the liabilities. These tests have disadvantages, as they require evidence and analysis of the company’s financial position. Depending on the size and structure of the organisation, it could possibly take months to produce a working financial statement.

In China, the EBL follows a slightly different approach and essentially combines both the ‘cash-flow test’ and ‘balance sheet test’. Article 2(1) provides that where a legal person fails to settle its debts when they fall due, and its assets are not enough to pay off all the debts, or it is obviously incapable of clearing off its debts as its assets are insufficient, it shall be liquidated according to the provisions of the EBL. The cash-flow test is relatively easy to apply in practice. The Courts would look at what the company is actually doing and determining if it is paying its debts as they fall due. The courts will ignore instances where there is a bona fide dispute as to the indebtedness. In addition, Article 2(2) provides that if the enterprise is facing the probability of losing the ability to pay off its debts, the enterprise can be admitted to the procedures of reorganisation under the EBL. This is essentially the balance sheet test whereas the shortfall of assets in relation to liabilities is not enough, thus the company is technically insolvent. The company may still be able to make payments to creditors as they fall due; this is also known as ‘imminent insolvency’. This test is a mechanism that is best used by the debtor as they would have a better understanding of the enterprises’ financial well-being. This uncommon combination emanates from a fear that there will be a “bankruptcy boom” with an easily satisfied bankruptcy test, and perhaps even an abuse of procedure to evade

143 Ibid, 87.
debts. Despite this consideration, the balance sheet test, as such, creates unnecessary obstacles to commencing bankruptcy proceedings.\textsuperscript{144}

Article 7 of the EBL, which concerns the filing of the bankruptcy application, further complicates the process. It is necessary to read both Articles 2 and 7 together in order to understand the procedure. Article 7 of the EBL gives both the debtor and creditor the right to file bankruptcy applications, although they are subject to different conditions.\textsuperscript{145} The creditor only has to be concerned with the cash-flow test, as the burden of proving a balance sheet test, would be difficult. Most creditors would not have access to this confidential information. The creditor would file for a liquidation of the company as its remedy in bankruptcy. Conversely, the debtor has the ability to apply either the balance sheet test or the cash-flow test. The debtor would have insider knowledge of the financial situation of the company and meeting the requirements of an imminent bankruptcy under the balance sheet criteria.

There are still numerous issues surrounding these tests and application. For instance, the term ‘inability to pay’ can be defined in numerous different ways. For example, if the debtor defaults on one payment by a day to single creditor, would this be sufficient for a creditor to file an application for liquidation? There is a high probability of misuse and wasting of the Court’s resources as the People’s Court has fifteen days to determine if it will accept a bankruptcy case from the date of filing; however, there are no specific standards provided by law to guide the Courts in these determinations. Further regulations and guidance from the government in this area are required.

\textsuperscript{145} Ibid.
3.4 The Role of a Bankruptcy Administrator

The concept of an administrator was first introduced in the 2002 draft of the new bankruptcy law and Chapter 3 of the EBL addresses the role of the administrator.146 The development of the administrator is a new mechanism in Chinese Bankruptcy Law that is designed to be more effective than the committee structure under the old regime. One of the important differences is that administrators are now professionals such as lawyers, accountants, insolvency specialists, liquidation firms and public intermediary bodies, whereas under the old system, the bankruptcy committee consisted of relevant government departments, planning commissions and creditor committees. The aim of this change was to eliminate the bureaucracy of the committee and place the company into the hands of a professional able to use their professional skills dealing with the bankruptcy company. Professor Wang notes:

> It can be expected that along with the implementation of the new bankruptcy law, bankruptcy administration will emerge as a new profession in China … After the promulgation … there will be a hot and heavy mission to train a large number of practitioners in bankruptcy administration in a short term and even keep that training going.147

As the central figure in the bankruptcy proceeding, the administrator has a variety of responsibilities to different parties. Above all, the administrator has a duty to perform his or her duties in accordance with the law and report to the People’s Court. Moreover, the administrator must also accept supervision of the creditors’ meeting and creditors’ committees.148 The administrator must sit in on the creditors’ meeting, report on the performance of its duties to the creditors’ meeting and answer questions.149 The

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146 Chapter 3, 2006 EBL.
148 Article 23, 2006 EBL.
149 Ibid.
The administrator undertakes the management and liquidation of the bankruptcy estate. In such, the office of administrator has the following features: 151

1. **Neutral position of the bankruptcy administrator.** The administrator is not to be affected by the substantive legal issues in bankruptcy proceedings. The administrator shall be representative for neither the creditors or state agencies, nor that of the debtor, but shall remain a neutral organization.

2. **Professional Status.** The administrator should be professional that is specialised in the field of administration.

3. **Explicit Functions of the Bankruptcy Administrator.** The administrator shall exercise a duty of care in addition to carrying out his statutory functions. Where an administrator causes loss to creditors due to intentional acts or gross negligence, then he or she is subject to civil and criminal liability.

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150 Article 25, 2006 EBL.
4. **Administrator Centrism.** The use of a system that encompasses all of the debtor’s estate, and is placed with the administrator for liquidation, safekeeping, operation and necessary disposal in order to better protect the interests of creditors.

3.4.1 **Appointment of the Administrator**

The appointment of an administrator occurs at the beginning of a bankruptcy case. The People’s Court hearing the case will make an order to accept the case and will designate an administrator at that time.\(^{152}\) The administrator position will be held by an individual, or a team in larger cases. The team will be composed of persons from the department or institution concerned, or by a legally established law firm, accounting firm, bankruptcy liquidation firm or any other public intermediary body.\(^{153}\) The Court has the ability to appoint an administrator after consultation with a public body in order to select someone who meets the requirements or has sufficient professional experience in a related field that would be of benefit to the administration of the bankrupt. In addition, if a person or body meets any of the following circumstances, they will not be eligible to hold the position of an administrator:\(^{154}\) 1) having been criminally punished for a calculated crime; 2) having ever had its certificate for practicing in a related field revoked; 3) having an interest in the case; or 4) other circumstances in which the People’s Court deems that it is inappropriate for the person or body to hold the post as administrator.

Where the Court appoints an administrator, and there are checks and balances in order to insure that the proper administrator was selected for the bankruptcy case.\(^{155}\) The creditors

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\(^{153}\) Article 24, 2006 EBL.

\(^{154}\) Ibid.

\(^{155}\) See Section 3.4.3.
have the ability to remove an administrator by applying to the People’s Court if he or she does not perform his duty legally and fairly, or he or she is deemed to be incompetent.\(^{156}\)

When a debtor applies to the Courts for bankruptcy proceeding in which a reorganisation of the company is sought, the debtor can apply to the People’s Court to have the administrator hand back property and business affairs to the debtor, and the administrator’s functions and powers provided for under the EBL may be exercised by the debtor.\(^ {157}\) The administrator supervises the process and offers guidance and insight. This regime is similar to the ‘debtor in possession’ or a ‘Chapter 11 bankruptcy’ in the USA.

### 3.4.2 Qualifications of the Administrator

The qualifications of the administrator are not addressed in the EBL; however, as with many pieces of Chinese legislation, the following regulations provide direction in how to address these issues. In the Rules Concerning Appointment of Administrator in Hearing the Bankruptcy Cases, the Supreme Peoples Court (SPC) excludes the following parties as a bankruptcy administrator: 1) individuals that have been given administrative penalties or disciplinary sanctions because of their intentional actions or gross negligence in their practice or business operations and the time period is within the past three years; 2) individuals that have been investigated for suspected violations by relevant authorities; 3) individuals who have been struck from the administrator roster by the People’s Court because of improper performance of their duties; 4) individuals that have refused acceptance of the appointment by the People’s Court, and the time period is less than three years since the date they were deleted; 5) individuals that do not possess
professional qualifications for the role of administrator; 6) individuals that do not have a
civil capacity; and 7) other situations which in the judgment of the People’s Court will affect the Administrators proper performance and duties.158

The long-term goal is for administrators to be professionals with the necessary expertise and background to execute their responsibilities diligently and effectively. Eventually, it is anticipated there will be requirements for a special license for bankruptcy administrators and a uniform examination will be established.159 It is estimated that this is many years away; however, in the interim, it is important for China to begin to establish a training and education program for current, potential and future administrators.160

3.4.3 Selection of an Administrator

The selection process of an administrator was further addressed in the Supreme People’s Court Bankruptcy Administrator Designation Provisions, which outline the process for selecting administrators using a panel. Outside of the four municipalities — Beijing, Tianjin, Shanghai and Congqing — a higher People’s Court directly controlled by the Central Government indicates the designated members on the panel available to become an administrator.161 Where the bankruptcy of a financial organisation is involved, the Courts are required to invite a panel consisting of members in the respective jurisdiction with adequate resources to bid for the appointment as an administrator. Bankruptcy cases

160 Ibid.
of enterprises that have a national influence with assets in multiple Courts’ jurisdictions are required to do the same. There must be a minimum of three panel members from intermediary institutes for bidding.\textsuperscript{162}

People’s Courts set the various criteria for the selection of an administrator. These will vary from jurisdiction to jurisdiction. For example, Beijing has developed a points-based system of a total score of 100 for each applicant as an administrator. This is based on the selection criteria of six different attributes of Certified Public Accountants:\textsuperscript{163}

\textbf{Table 1: The Selection Criteria for Administrators}

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Annual turnover of firm</td>
<td>20</td>
</tr>
<tr>
<td>Size of firm by headcount of qualified professionals</td>
<td>20</td>
</tr>
<tr>
<td>Practical experience in bankruptcy cases</td>
<td>30</td>
</tr>
<tr>
<td>Relevant number of liquidation reports issues</td>
<td>15</td>
</tr>
<tr>
<td>Number of published articles</td>
<td>5</td>
</tr>
<tr>
<td>Professional liability insurance</td>
<td>10</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>100</strong></td>
</tr>
</tbody>
</table>

The process through which an administrator is selected in an ordinary bankruptcy case takes the form of random means, such as a rotation, blind drawing or lottery. With regard to complex and influential cases, the Courts must employ a competitive bidding scheme to determine the administrator.\textsuperscript{164} Lastly, in selecting the administrator in the bankruptcy of financial organisations, the Court must follow the recommendation of an administrator made by a State regulatory body.\textsuperscript{165}

\textsuperscript{162} Ibid.

\textsuperscript{163} Ibid.


Overall, the selection process has been welcomed as a positive improvement; however, criticisms of its application and procedures have emerged.\textsuperscript{166} Firstly, because of the large number of administrators on some panels, the wait between cases can be substantial. Secondly, the rotation system does not take into account that a firm or practitioner might have some special expertise or relevance for a specific case. Thirdly, the scoring system, such as the one used in Beijing, does not rate actual experience in insolvency cases as highly as some practitioners believe it should be (it is only 30 per cent of the total criteria). Finally, the registers of administrators are incomplete because the relevant People’s Courts are awaiting updates from the provinces. The lists are not amended as often as necessary to reflect changes arising from death, retirement or disqualification of panel members.\textsuperscript{167}

There is an additional issue regarding professional liability insurance requirements. Shi notes:

> Interestingly there has been thus far no such professional liability insurance specifically designed for bankruptcy administrator available in China. Though the administrator may carry professional liability insurance generally designed for lawyers or accountants, there are some problems which create hesitancy of potential administrator to participate. As such, the China Insurance Regulatory Commission (CIRC) and insurance companies are currently actively devising an insurance product suitable for administrator to carry.

This is a complex issue as the insurance industry is still in its infancy in China. With the need for such an insurance product, it is only a matter of time before such a suitable insurance product will be available for administrators.

\textsuperscript{167} Ibid.
3.4.4 Remuneration of the Administrator

The remuneration of the administrator is determined by another SPC rule, the Rules Concerning the Remuneration for the Administrator in Hearing the Bankruptcy Cases. The remuneration is calculated based upon a percentage of the distributable property of the bankrupt enterprise (see Table 2).

**Table 2: The Remunerations Provisions under the New Bankruptcy Law**

<table>
<thead>
<tr>
<th>Total value of distributing Properties (RMB)</th>
<th>Administrator’s remuneration (percentage of total value of distributable assets)</th>
</tr>
</thead>
<tbody>
<tr>
<td>≤1 million</td>
<td>12% or less</td>
</tr>
<tr>
<td>&gt;1 million to 5 million</td>
<td>10% or less</td>
</tr>
<tr>
<td>&gt;10 million to 50 million</td>
<td>8% or less</td>
</tr>
<tr>
<td>&gt;50 million to 100 million</td>
<td>6% or less</td>
</tr>
<tr>
<td>&gt;100 million to 500 million</td>
<td>3% or less</td>
</tr>
<tr>
<td>&gt;500 million</td>
<td>0.5% or less</td>
</tr>
</tbody>
</table>

The rationale behind this percentage scheme is fourfold. It is not acceptable to adopt a remuneration system on an hourly basis because the relevant implementing system has yet to be established as there is a high moral hazard risk and there is a lower recognition by society. Moreover, remuneration on a percentage basis is simple and easily operated and accepted by the public. Thus, remuneration on a percentage basis gives more incentive to an administrator to collect more property and the interests of the creditors are better protected. Most countries adopt a remuneration scheme on a percentage basis.\(^{168}\)

The People’s Court reserves the right to adjust the remuneration paid to an administrator within a floating range of 30 per cent from the fixed rate.\(^{169}\) These adjustments may be made to offset the complexity of the bankruptcy case, the administrator’s performance,


contribution to a business’s revival, risks borne, responsibilities undertaken, the local residents’ disposable income, and the price level of the debtor’s location.\footnote{Ibid.} The creditors’ committee reserves the right to file an objection to the People’s Court where it objects to the level of remuneration paid to an administrator.\footnote{Article 28, 2006 EBL.}

In instances where the debtor’s financial health is such that there are insufficient assets to pay the administrator, the administrator may apply the People’s Court to have the case closed. However, there is an exemption where creditors and other interested parties are willing to advance funds to the administrator for a forensic investigation to trace the debtor’s assets. The administrator can receive remuneration from the advance fund so that the bankruptcy procedure can continue.\footnote{Article 12, SPC Provisions on the Determination of Administrator’s Remuneration in Hearing Bankruptcy Cases.; Shi Jingxia, ‘Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China’s Transition to a Market Economy’ 2007 (16) Norton Journal of Bankruptcy Law and Practice 645, 666.} This feature of the law would generally be used where there has been a fraudulent bankruptcy and the debtor has moved money and property in order to defeat creditors.

\section*{3.5 Security, Creditors and Workers’ Rights}

The change from the liquidation-based bankruptcy system of the 1986 EBL to a modern system that includes both liquidation and rehabilitation brought with it a need to readdress the issues of secured debts and creditors’ rights. Under the 1986 EBL, secured assets and debts were not included within the scope of the ‘bankruptcy assets’ and were not considered relevant, except for when the proceeds of the sale of a secured asset exceeded the amount of the secured debt and were therefore available for distribution to
other creditors. This position was further confirmed in 2002 with SPC provisions that excluded secured debt from the definition of ‘bankruptcy claims.’ The provisions expressly stated that any assets subject to a mortgage, lien or pledge did not constitute bankruptcy assets, since the 1986 EBL did not make provisions for the dealings of secured assets other than in the context of bankruptcy liquidation. It was assumed that the creditors’ committee would limit their dealings to the disposal of non-secured assets and would leave the secured assets to be dealt with by the secured creditors.

It was suggested that these changes were made to ensure that after the People’s Court accepted a bankruptcy application, ‘the debtor’s assets can be better identified and managed, a fair settlement of claims and debts can be achieved and the lawful interests of the creditors and the debtor can be protected.’ The effects of these changes are that secured assets will be treated in the same way as unsecured assets, including the management and use of assets by the debtor or the administrator. There are exceptions, such as where a secured creditor is not subject to a stay of proceedings, and is able to enforce security rights independently of a bankruptcy proceeding.

3.5.1 Stay of Proceedings by Secured Creditors during Bankruptcy Proceedings

The EBL provides for an automatic stay on proceedings against the debtor’s assets from the date the People’s Court accepts the bankruptcy application. Article 19 of the EBL states that ‘after a bankruptcy application is accepted by the People’s Court, the

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preservation measures against the debtor’s property shall be removed and the enforcement proceedings shall be suspended’. It does not make any specific reference to actions by secured creditors; however, such actions appear to be dealt with by the general reference to ‘enforcement proceedings’, thus encompassing both secured and unsecured creditors.  

During the drafting process, the automatic stay provisions applying to all creditors were not universally supported. Godwin writes that ‘Professor Wang Xinxin, for example, argued that this was inconsistent with international practice and that the rights of secured creditors should only be stayed during a restructuring. In his view, a stay on enforcement action by secured creditors upon the acceptance of a bankruptcy application could not be justified on the basis that it would facilitate a settlement or restructuring.’  

If the debtor wished to avoid an action such as this, they should enter into a series of settlement agreements with the secured creditors individually, before a restructuring process could begin. This view is very persuasive, particularly the suggestion that a debtor should apply for restructuring before the debtor defaults on its debt obligations since each action would, thereby, forestall any adverse enforcement by secured creditors.

Article 75 of the EBL provides ability for foreign creditors to seek relief from an automatic stay, where they can prove that ‘the property is likely to be damaged, or to be devalued obviously in the extent to harm the rights of the secured party’. This can only happen after the restructuring plan is approved at the creditors’ meeting and approved by the Court. The stay of proceedings will remain in place except where a creditor can successfully apply for relief of the stay. If the restructuring of the company fails, the

179 Ibid.
180 Article 75, 2006 EBL.
debtor would then be declared bankrupt and the secured creditors would be able to exercise the security agreements and claim any rights they enjoy to the particular property under Article 109 of the EBL.

3.5.2 Enforcement of Security by Secured Creditors

One of the key issues for secured creditors in a bankruptcy proceeding is the ability to enforce their security over the relevant assets of the debtor and recover debts owing to them without delay or impediment. The EBL provides three provisions for secured creditors to exercise their rights: 1) Where the People’s Court permits a secured creditor to resume the exercise of a security right, where it is likely to be damaged or devalued during a restructuring proceeding;\(^\text{181}\) 2) Where the People’s Court confirms a settlement agreement under the provisions of the EBL, a security right holder enjoys a particular right from that date of settlement;\(^\text{182}\) and 3) Where a People’s Court declares a debtor bankrupt, a security right holder will enjoy the security right to the particular property that is secured.\(^\text{183}\)

Godwin argues that Article 109 does not expressly provide that secured creditors may exercise their security rights independently of the proceedings in order to receive payment in priority.\(^\text{184}\) However, when Article 109 is read with Articles 110 and 113, it appears that if a secured creditor fails to receive payments in full i.e., can prove for the balance after exercising its priority payment rights, the unpaid claim, shall be regarded as a common claim in bankruptcy.\(^\text{185}\) The secured creditor portion of unpaid claims will

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\(^{181}\) Ibid.
\(^{182}\) Article 96, 2006 EBL.
\(^{183}\) Article 109, 2006 EBL.
\(^{185}\) Article 110, 2006 EBL.
then be ranked after settlement of bankruptcy expenses, employee’s claims and social insurance benefits in accordance with Article 113.

Creditors in civil law jurisdictions have what is known as the ‘right of separation’. This has traditionally been a right supporting the separation of pledge rights, mortgage rights, lien rights and other preferred rights. This has been recognised in theory; however, it is not expressly included in the EBL. In the Securities Law, there is recognition of four types of asset security, being mortgages, pledges, liens and deposits each of which are acknowledged and dealt with under separate legislation.

3.5.3 Role of the Administrator in Dealing with Secured Assets

Where secured creditors have their recovery actions subjected to stay of proceedings, there is a question as to the extent of the administrator’s powers to use and dispose of secured assets within this period. This is a key issue as it goes to the heart of proprietary rights in China, and the extent to which pre-existing rights of secured creditors are respected or compromised in a bankruptcy proceeding.

Possessory securities such as a pledge or a lien are addressed within the EBL. Article 37 provides that ‘after a bankruptcy application is accepted by the Court, an administrator may retrieve the pledge property or property with a lien property by paying off a debt or providing a security accepted by the creditor’. This means that an administrator may not extinguish a pledge or lien in the bankruptcy proceedings, except where the debt has

187 Ibid.
188 Article 37, 2006 EBL.
been repaid or where an agreement has been struck with the creditor that gives replacement security that is to creditors’ satisfaction.

In the case of non-possessory securities, such as a mortgage, it is unclear whether an administrator has the power to extinguish the mortgage and sell the property and assets. If so, whether the secured creditor has any influence or control of the process in which the assets are to be sold, and in particular, the timing of the sale. There are competing interests when the mortgage debt is greater than the asset value. The secured creditor would naturally want to maximise the proceeds of the sale to satisfy as much of the debt as possible. The administrator however, may be more concerned with the quick sale of the asset to minimise delay.189

There is another concern, which relates to the use of the mortgaged assets by the administrator and the extent of protection should be given to the secured creditor of that asset against possible devaluation prior to the commencement of the proceedings. The UNCITRAL Legislative Guide recommends that the creditor, upon application to the Court, should be entitled to protection of the value of the asset in which the creditor has an interest. Protective mechanisms that may be provided by the Court include cash payments by the estate and provisions for additional security interests are recommended to ensure protection of the asset value.190

Under the EBL the administrator is given a wide variety of duties to perform. In relation to the assets of the debtor, the administrator is charged with managing and disposing of

the debtor’s property. This contrasts with the responsibilities of the creditors’ meeting. The creditors’ meeting is given the power to ‘adopt a plan for management of the debtor’s assets’. There is clearly a difference in the language, as the latter words do not expressly confer power on the creditors’ meeting to decide on the disposal of the debtor’s assets prior to the commencement of a proceeding. The only specific reference is to the power to decide on the disposal of assets in respect of ‘bankruptcy assets’ and this can only occur after the People’s Court has made a declaration of bankruptcy.

There are no express provisions in the EBL with respect of the administrator’s powers to use and dispose of secured assets in the period prior to the commencement of a bankruptcy proceeding. If the law is to permit an administrator to use or dispose of these assets during this period, it is necessary to clarify the circumstances in which this may occur, and to the conditions to which an administrator would be subject. In certain circumstances this is normal practice to preserve the value of the asset. It is essential that the SPC make a ruling on this matter in order for the proper functioning of the law, and to define the terms in which the assets may be dealt with. This is critical, as a new type of security described as a ‘floating mortgage’ or a ‘floating charge’ has now been recognised under the new Property Rights Law. This enables a creditor to take security over present and future production equipment, raw materials, semi-finished products and finished products. If the debtor defaults, the mortgage will crystallise and the creditor is able to act on its security interest. These types of agreements have many more

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191 Article 25(8), 2006 EBL.
192 Article 61(8), 2006 EBL.
194 Ibid, 770.
contractual restrictions, such as negative and positive covenants, over the debtor’s business operations.

3.5.4 Issues relating to Workers’ Rights

Issues surrounding workers’ interests were some of the most contentious issues in the drafting of the new bankruptcy law and the primary reason for the last few years of delay in the promulgation of the new law. In the 1986 EBL, there were arguments over the preferring of claims of secured creditors over that of workers, and the ranking of employees after paying the expenses of the bankruptcy. During the mid-1990s, however, there were a series of Supreme People’s Court judicial interpretations that influenced the policy by which priorities of employees were to be determined. A 1994 judicial interpretation provided that any land use rights from an SOE would be sold at auction or tender and the proceeds from the sale of the rights were to be used for the resettlement of the SOE’s employees. In 1996, an additional notice clarified the view that the rights of workers took priority over that of secured creditors. In the event that disposals of the land use rights were insufficient, monies would be allocated from the secured and unsecured assets of the SOE. In addition, if this were still insufficient, the Local Government would be responsible for bearing these social security costs. This was applicable to all SOE’s employees and included certain pension and medical benefits as well. It became apparent that the two different priority schemes were contradictory and this sparked debate over which of the models should provide the basis for the new law.

197 Article 32, 1986 EBL.
198 Article 37, 1986 EBL.
201 Ibid.
The solution was to create a so-called ‘super-priority’ that employee's enjoyed against a bankrupt SOE, thus appeasing trade unions and employees. In addressing these conflicting issues, Shi notes:202

Nevertheless, it seems hard for China to reconcile social stability with a market economy during its stage of economic transition especially when the market economy conflicts with its entrenched traditional values and methodologies. The contest between secured creditors and employees with respect to the priority in bankruptcy distribution touches upon an issue inflicted by the past historical burden and present reform pressures.

The balancing of the rights of secured creditors, against the interests of citizens is a difficult act. The issues surrounding a bankruptcy of a SOE often result in protests, strikes and demonstrations by workers that exert pressures on the PRC government.203

Numerous drafts of the new EBL during the early 2000s dealt with the competing issues described above and a compromise was made in dealing with employees’ rights. Eventually this compromise resulted in two different ways in which employees are to be dealt with: one applies before 27 August 2006, and the second applies after this date. The cut-off date was the day the 2006 EBL was promulgated.204 A supplementary provision allows for the payment of workers’ salaries and social security benefits from the bankruptcy estate as a first priority. It does allow for a retroactive claim when a bankruptcy application is filed after the date of promulgation of the law.205 This grandfathering protection is essential for SOE workers that may have pre-existing claims for health benefits, pensions and back wages.

203 Ibid.
205 Article 132, 2006 EBL.
In the 2006 EBL, the super-priority of employees no longer exists. They now take priority after secured creditors and bankruptcy expenses and before taxes and other unsecured creditors.\textsuperscript{207} The policy mirrors many international insolvency regimes, where workers’ claims (including claims for wages, leave or holiday pay, allowance for other paid absence and severance pay) constitute a class of priority in insolvency. In a number of cases, these claims rank higher than most other priority claims, specifically tax and social security.\textsuperscript{208}

The 2006 EBL provides for statutory protection of the employees’ rights. Firstly, there is the provision that the People’s Court shall in accordance with the law, ‘safeguard the lawful rights and interests of the enterprises staff and workers and investigate for the legal liability of the managerial personnel of bankrupt estate’.\textsuperscript{209} This is a protective mechanism enabling the Courts to take the best interests of the employees under consideration and use its power to protect them. When the debtor has made an application for a bankruptcy reorganisation, the application must outline a plan for resettlement of staff and workers when it is submitted to the Court.\textsuperscript{210} The staff, workers and trade unions are entitled to have representatives in attendance at the creditors’ meeting, to express their opinions on relevant matters.\textsuperscript{211} The creditors’ committee must include a member who is either a representative from the staff and workers or that of the

\textsuperscript{207} Article 113, 2006 EBL.
\textsuperscript{209} Article 6, 2006 EBL.
\textsuperscript{210} Article 8, 2006 EBL.
\textsuperscript{211} Article 59, 2006 EBL; See also, Xin Ge, ‘Creditors’ Meeting and Creditors’ Committee in Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds) China’s New Enterprise Bankruptcy Law: Context, Interpretation and Application (2010) 185; See especially, Haizheng Zhang, ‘Corporate Rescue’ in Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds) China’s New Enterprise Bankruptcy Law: Context, Interpretation and Application (2010) 207.
trade union.这些问题的分类将导致不同的组别和这些索赔将被分别投票，当有一个重新组织的计划时。

这些变化在破产程序中处理工人的权利，现在是与其它破产制度一致的。对工人的权利放置在优先顺序中给予工人保障，他们的索赔将有一个优先权被支付。

3.6 Corporate Restructuring

企业重组是一个由许多名字，包括“康复”，“组织”，‘Chapter 11’，‘corporate rescue’ 和‘fresh start’。一个最重要的新EBL的元素是第8章，它处理了可以康复的组织。

在过去的十年里，破产制度改革，包括企业救援和康复，这现在是新中国EBL的核心。这个特性与美国破产法第11章的程序，这是1978年第一次主要破产法律，提供康复的特性，度过了破产。

企业重组将往往不仅仅只是财务的。破产将使用‘呼吸空间’提供的自动暂停，关闭或出售亏损的部门，减少多余的员工，削减员工数，裁员，削减公司车辆等。成功的第11章将通常产生一个更小，更精简的公司，有减少的债务（和兴趣）负担，再次能集中于它做好生意的类型。

212 Article 67, 2006 EBL.
213 Article 82, 2006 EBL.
Corporate reorganisation is not new to the Chinese bankruptcy regime. As Booth notes, ‘it was possible both under the 1986 EBL and PRC Civil Procedure Law – but more in theory than in practice. The number of cases involving corporate rescue in China under the old laws was close to zero.’ The reorganisation procedures were only available to SOEs in cases where a creditor filed the bankruptcy application. Thus, where the SOE had a superior department that was in charge, only the government was permitted to apply for a reorganisation of the SOE. This resulted in limited reorganisation proceedings. Further, the reorganisation process was strongly politicised, hampering the functioning of the rescue procedure and resulting in very low or non-existent use.

Various other mechanisms of mergers, asset-swaps and the Chongchung approach were used in reorganising non-performing SOEs. There was always a high level of administrative intervention, as these were pre-planned bankruptcies directed by the state. This was a different style of reorganisation that mostly dealt with making inefficient SOEs more efficient in order to avoid unemployment and promote socialist harmony.

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219 Ibid.
221 The Chongchung approach was a term coined after the successful use of “Purchase-Sale Restructuring” whereby the local government used its administrative powers to hive off the profitable assets off from the old enterprise and create a new enterprise. There are three principles that are adhered to: 1) capital marketing and floating principle; 2) law abiding principle in the procedure of asset transfer; and 3) principle of protecting creditors at the highest degree when actively negotiating with creditors; See especially, Wang, Weigou, Changchung Approach: A New Scheme for Debt Restructuring in China China University of Politics and Law, 2000.
These approaches were the preferred means of dealing with struggling SOEs, rather than bankruptcy proceedings.\footnote{222}{Rebecca Parry and Haizheng Zhang, ‘China’s New Corporate Rescue Laws: Perspectives and Principles’ (2008) 8(1) Journal of Corporate Law Studies 113, 118.}

### 3.6.1 Requirements for Application to the Proceedings

Following other modern bankruptcy regimes, China allows both debtors and creditors to apply directly to the People’s Court.\footnote{223}{Article 70, 2006 EBL.} This process is available for all legal person enterprises and is no longer limited to SOEs. It is important for both parties to have access to these proceedings as the debtor may have an inside working knowledge of the financial health of the company long before others. The presence of an effective liquidation procedure will potentially encourage company managers to seek alternatives (at an earlier stage).\footnote{224}{Ibid, 127.} A company is able to place itself into the procedure, and have the probability of a more successful post-reorganisation outcome than that of a straight liquidation. An early implementation will normally lead to a more successful outcome since the company will be shielded from the demands of creditors at an early stage. Timely provision of expert help can prevent further problems.\footnote{225}{Ibid, 127.} Conversely, creditors have the ability to reorganise the company and minimise the losses that would be incurred if the company were to be liquidated, as a company that is a going concern is usually more valuable than its pieces.

In keeping with the market-based nature of the new EBL, there are no requirements for government consent to bankruptcy proceedings, with the exception of certain financial institutions. In addition, the resettlement of employees is no longer a central concern of
the bankruptcy law, thus releasing local governments of their responsibilities for the welfare of unemployed workers.\textsuperscript{226}

One of the problems that the EBL has with debtor-initiated reorganisation proceedings is lack of awareness of the procedure and the positive outcomes that can come from it. Within China the concept of bankruptcy is viewed as an act of dishonour and it will take time for this social stigma to be overcome. In addition, business managers may be reluctant to admit that their business is in difficulty, and they may fear that they will lose their jobs if proceedings are initiated.\textsuperscript{227} There needs to be more education on the benefits of bankruptcy reorganisation as a viable way of rescuing a troubled business.

\textbf{3.6.2 Administration and Debtor in Possession within the Proceeding}

Once an application for bankruptcy has been filed in the People’s Court, the Court must make a decision within fifteen days from the date of application as to whether or not to accept the proceeding. In special circumstances, time may be extended by an additional fifteen days upon approval by the next higher level of the People’s Court.\textsuperscript{228} The People’s Court considers the application for reorganisation and if it conforms to the provisions within the law, it makes an order to reorganise the debtor.\textsuperscript{229} The principles to be applied in reaching a decision to reorganise the debtor have not been elaborated, and consequently the wide discretion the Courts have to accept a proceeding have not been outlined. As such, there is the possibility of the Court conducting itself in a way that is not in accordance with the true intention of the law.\textsuperscript{230}

\textsuperscript{226} Ibid.
\textsuperscript{227} BG Carruthers and TC Halliday, Rescuing Business (1998) 249.
\textsuperscript{228} Article 10, 2006 EBL.
\textsuperscript{229} Article 71, 2006 EBL.
The reorganisation period commences on the day that the People’s Court makes an order to reorganise and continues in force until the reorganisation is terminated.\textsuperscript{231} During this period, investors of the debtor may not request a distribution on returns from their investments.\textsuperscript{232} There is also a further restriction upon directors, supervisors and senior management not to transfer shares held by them, to any third party except where a transfer is approved by the People’s Court.\textsuperscript{233} Rights to exercise security against particular property of the debtor are suspended during the reorganisation period. However, there is an exception where secured property is likely to be devalued or where it harms the rights of a secured creditor. The secured creditor may apply to the People’s Court to exercise the specific security right.\textsuperscript{234} As Shi notes, there is no mention of the wider concept of ‘adequate protection’ for secured creditors as with US Bankruptcy Code and other international insolvency regimes.\textsuperscript{235}

3.6.3 Interests of Parties Affected by the Proceedings

Among the different groups of creditors — secured and unsecured, company managers, its shareholders, local government, its employees and the local community in which the debtor has operations — a variety of issues affect each group differently and there is no consensus of interests. Effective governance of the proceedings to balance the interests of these groups is essential. In the drafting process of the new EBL, this was a contentious and debated issue.\textsuperscript{236}

\textsuperscript{231} Article 72, 2006 EBL.
\textsuperscript{232} Article 77, 2006 EBL.
\textsuperscript{233} Ibid.
\textsuperscript{234} Article 75, 2006 EBL.
There was a shift in the re-ordering of priorities from the 1986 EBL. As previously discussed, the super-priority of employees’ claims and the concept of the Iron Rice Bowl were abandoned. This went against a fundamental principle of the founding of the PRC and the Chinese Constitution, which hold that the working class is the ruling class.237 The Chinese social security system does not adequately protect the social security of the nation’s people due to its inadequacies. Employees can least afford to lose what they are owed, which explains their priority ahead of tax claims and that of creditors in cases where adequate social security is not available.238

Financial interest groups argued that the bankruptcy proceedings should not be used to serve the functions of a social security system.239 They pressed the view that adherence to international best practice and the ability to seek foreign and domestic investment into projects and companies was essential for the continued economic growth of the nation.

In summary then, various interests remain in conflict. Local Government officials continue to influence the decision making process in order to keep employees in jobs and maintain the social security networks in their municipality.

**3.6.4 How the Proceedings are to be Governed**

Good governance of bankruptcy proceedings is essential for a successful result. The interests of parties usually conflict and a process is necessary to keep the proceedings on-

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237 Article 1 of the Chinese Constitution (1982) states that: ‘The People's Republic of China is a socialist state under the people's democratic dictatorship led by the working class and based on the alliance of workers and peasants.’


239 Ibid.
track. The EBL provides some of the framework in addition to the Civil Procedure Law, Corporate Law and other laws govern the direction of the proceedings. One of the chief concerns is corruption and fraudulent conduct prior to and during the proceedings.

The administrator is essential in a restructuring process. The administrator is charged by the Court to perform his or her duties in accordance with the provisions of the EBL and any additional regulations by the SPC that are relevant.\footnote{Article 25, 2006 EBL.} As a Chapter 8 restructuring is a hybrid style of debtor-in-possession bankruptcy, the directors and management of the debtor are under the supervision of the administrator. Directors of the debtor are required to report, preserve the property of the company, carry out work as directed by the People’s Court, attend creditors’ meetings and honestly answer questions, remain in the area unless given the permission of the People’s Court to leave, and not take a position as a director, supervisor or senior executive of another company until the bankruptcy is concluded.\footnote{Article 15, 2006 EBL.}

The creditors’ committee is charged with another level of governance that is recognised by the People’s Court. It has responsibilities to supervise and assist in managing the disposition of the debtor’s property, supervise the distribution of bankruptcy property, convene creditors’ meetings and perform other functions and powers authorised by the creditors’ meeting.\footnote{Article 68, 2006 EBL.}

Shareholders and investors do not have the right to file for a bankruptcy application; however, once a proceeding has begun, a shareholder with at least ten per cent of the registered capital of the debtor may apply for a reorganisation of the debtor before it is

\footnote{Article 25, 2006 EBL.}
\footnote{Article 15, 2006 EBL.}
\footnote{Article 68, 2006 EBL.}
declared bankrupt.\footnote{Article 70, 2006 EBL.} The shareholder or investors may have a representative attend the creditors’ meeting to discuss the reorganisation plan.\footnote{Article 85, 2006 EBL.} In the event that the draft reorganisation plan includes a matter of adjustment to the rights and interests of the investors, a group of investors is to be established in order to take a vote on the matter.\footnote{Ibid.}

The EBL provides for protection against wrongdoing in dealing with the property of the debtor prior to the acceptance of a bankruptcy application.\footnote{Article 34, 2006 EBL.} Within one year of the application being filed, an administrator is entitled to request the People’s Court to annul the following avoidance transactions in order to recover assets that have been disposed, these include: 1) the transfer of property without consideration; 2) the transfer of property at an unreasonable price; 3) to secure property claims that are not secured with property; 4) to pay off a debt that is not yet due; and 5) the abandoning of claims of the debtor.\footnote{Article 31, 2006 EBL.} The above types of transactions are regarded as avoidance mechanisms.

It is obvious that directors and senior management of the debtor would know of the financial situation and pending bankruptcy, so these ‘back room’ deals are deemed invalid under the EBL and the People’s Court has the power to reverse them and recover property so it can be distributed to creditors. Another retrospective provision is that during the six months before a bankruptcy application is accepted by the People’s Court, if a debtor comes under the circumstances of Article 2 (where the debtor is unable to pay off a debt that is due, and his or her assets are insufficient to pay off all of the debts or there is an apparent lack of the ability to pay, but the debtor still pays off its debts to a specific creditor), an administrator is entitled to request to have these payments to
creditors by the debtor annulled, except where there is a specific repayment that benefits the property of a debtor.248

In addition, if the debtor concealed or transferred property to evade repayments of a debt, or fabricated a debt or claimed a false debt, an administrator may have these transactions deemed null and void.249 If a director, supervisor or senior executive of the debtor receives any abnormal income or property from the debtor, the administrator can recover this.250 These provisions within the EBL give the administrator and the creditor’s recourse against the debtor and its directors in recovering property and maximising the debtor’s assets for use in the restructuring proceedings. It is important to note that these types of provisions are part of the international best practice as found in bankruptcy regimes from around the world.251 The effectiveness of these laws is, however, in doubt because of weakness in the judicial system and lack of a proper insolvency infrastructure within China. This matter is discussed throughout Chapters 5 and 6.

3.6.5 Legal Liability of Individuals

Legal liability may fall upon a director, supervisor or senior executive of the debtor where the individual has breached the obligation of good faith and diligence resulting in bankruptcy of the debtor. Persons that have been found guilty of such acts will attract civil liability for damages and criminal liability where applicable. They are also prohibited from acting as a director, supervisor or senior executive for a period of three years from the date of termination of the bankruptcy proceedings.252 Where any of the

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248 Article 32, 2006 EBL.
249 Article 33, 2006 EBL.
250 Article 36, 2006 EBL.
252 Article 125, 2006 EBL.
acts of concealment and transfer of property has occurred in accordance with Articles 31, 32 or 33 encroaching on the interests of creditors, the legal representative of the debtor or other persons directly responsible for the violation are liable. If an involved person attempts to leave the local city or municipality without permission of the Court, the Court can detain the person to keep them from leaving, or issue a warrant for arrest if they have left and to have them returned. The administrator is also liable for failing to exercise duties diligently and faithfully. The People’s Court may impose fines. It there are any losses to a creditor, debtor or third party, the administrator assumes liability for compensation. In the event that any violation of this law constitutes a crime, criminal proceedings shall be instigated.

Criminal sanctions provide deterrence for illegal actions. What is lacking are positive directions and proper procedures of good governance and direction for good bankruptcy procedure. This need is further discussed in section 6.1.1, as is the need for a bankruptcy department and an administrator’s organisation to provide the framework for proper procedures and good governance.

3.6.6 The Framework for a Reorganisation

Where a creditor or the debtor wishes to begin a reorganisation, an application to the People’s Court must be made. In the event that a creditor applies for a liquidation of the debtor, either the debtor or a creditor that holds at least a ten per cent interest in the registered capital of the debtor may apply to the People’s Court for a reorganisation. Once the People’s Court examines the application and finds that it falls within the

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253 Article 128, 2006 EBL.
254 Article 129, 2006 EBL.
255 Article 120, 2006 EBL.
256 Article 131, 2006 EBL.
257 Article 70, 2006 EBL.
provisions of the law, it confirms the reorganisation and makes a public announcement of it.\textsuperscript{258}

Once approval for a reorganisation has been accepted, the debtor and/or administrator must draft a plan for reorganisation and submit it simultaneously to the People’s Court and to a creditors’ meeting within six months from the date that the Court made the order for the reorganisation of the debtor.\textsuperscript{259} In the event that the plan is incomplete and no just cause can be shown, the Court may extend the time for submission by an additional three months. When a plan is not submitted within the time limit, the Court must make an order to terminate the reorganisation period and declare the debtor bankrupt. Either the debtor or the administrator, depending on whether the debtor or the administrator applied for the proceedings, can make the reorganisation plan.\textsuperscript{260}

The plan itself should be comprehensive, cover all aspects required by the law, and provide a clear path for how the reorganisation is to occur. A draft reorganisation plan must include the following: 1) a business plan of the debtor; 2) a classification of the claims; 3) a plan for the adjustment of claims; 4) a plan for repayment of the claims; 5) a time limit for implementation of the reorganisation plan; 6) a time limit for supervision over implementation of the reorganisation plan; and 7) other plans favourable to the reorganisation of the debtor.\textsuperscript{261} There is some ambiguity and the potential for disagreement regarding the inclusion of ‘other plans favourable to the reorganisation’.

\textsuperscript{258} Article 71, 2006 EBL.  
\textsuperscript{259} Article 79, 2006 EBL.  
\textsuperscript{260} Article 80, 2006 EBL.  
\textsuperscript{261} Article 81, 2006 EBL.
Creditors play an important part in discussions regarding the draft reorganisation plan. They are divided into four different groups along the lines of the class of creditors in priority. These are: 1) creditors with a secured right to property; 2) employee claims; 3) tax claims; and 4) ordinary claims. The Court may create a sub-group of small amount claims within the group of ordinary claims where it deems it necessary to protect the interests of small creditors with little influence in voting on the reorganisation plan.262 Within 30 days of the draft reorganisation plan being received the People’s Court must call a creditors’ meeting for a vote. Where the majority of creditors in the same group approve the plan and their claims represent at least two-thirds of all claims, it is considered approved.263 When all the different creditors groups approve the plan with these majorities, then the plan is approved, pending certification by the People’s Court. The debtor or the administrator must submit the plan to the People’s Court within ten days of the passing of the plan, and the Court will examine the plan to see if it falls within the provisions of the law. If approved, the Court will make an order to approve it within 30 days of the receipt of the application. If the plan is not accepted, the debtor must begin an immediate liquidation.264

There are two notable restrictions in the voting on the plan. Firstly, a reorganisation plan may not make a reduction of social security benefits payable and owned by the debtor which include the following: salaries, medical treatment, injury and disability allowances, pensions, old age insurance and medical contributions to employees, compensation to employees in accordance with the provisions of law or administrative regulations.265 The creditors of such contributions cannot participate in the voting on the

262 Article 82, 2006 EBL.
263 Article 84, 2006 EBL
264 Article 86, 2006 EBL.
265 Article 82(2), 2006 EBL.
draft reorganization plan as there would be a natural bias for additional payments.\textsuperscript{266} Secondly, where there is a question of adjusting the rights and investors, a group of investors shall be established in order to take a vote on the matter.\textsuperscript{267}

In the event that all voting groups do not adopt the draft reorganisation plan, the debtor or the administrator may consult with those groups, and negotiate an agreement that meets the requirements of the group. This agreement may not encroach on the interests of any other group. The groups may take an additional vote after the meeting to approve the plan.\textsuperscript{268} The Court has the ability to introduce a ‘cram-down’ procedure where a voting group fails to adopt the reorganisation plan by re-voting or refusing to vote.

The debtor or administrator may apply to the People’s Court to force the acceptance where it meets the conditions of the law.\textsuperscript{269} The requirements for a relatively high threshold of two-thirds of the groups’ interest may be a difficult number to achieve where there are substantial interests. This procedure gives the Court some latitude in approving a plan that just misses this mark. Where a plan fails to be adopted in accordance with the cram-down process of Article 87, the reorganisation plan fails and the People’s Court will make an order for the termination of the reorganisation procedure and declare the debtor bankrupt.\textsuperscript{270}

Once the People’s Court accepts the plan, the plan is implemented and put into action by the debtor. If an administrator has taken over the debtor’s business, then control is

\textsuperscript{266} Article 83, 2006 EBL.
\textsuperscript{267} Article 85, 2006 EBL.
\textsuperscript{268} Article 87, 2006 EBL.
\textsuperscript{269} Ibid.
\textsuperscript{270} Article 88, 2006 EBL.
handed back to the debtor.\textsuperscript{271} The administrator is still to act as a supervisor of the debtor during the reorganisation period, thus resulting in a hybrid debtor-in-possession model. The debtor must make progress reports to the administrator on the progress of the plan and on the financial status of the company.\textsuperscript{272} Once the supervision period ends, the administrator is to report to the People’s Court and all interested parties have the opportunity to review the administrators report at this time.\textsuperscript{273}

Once the People’s Court approves a reorganisation plan, it has binding force on the debtor and all creditors. If a creditor fails to declare a claim, he or she poses the ability to exercise rights in the implementation of the reorganisation plan. Upon completion of the plan, a creditor then may exercise his or her right in accordance with the specified conditions of the plan for repayment in the same class of claims.\textsuperscript{274} If the debtor is unable, or refuses to implement the reorganisation plan, the Court at the request of the administrator or an interested party, must make an order for the termination of the reorganisation and declare the debtor bankrupt.\textsuperscript{275}

Upon the completion of the reorganisation, the debtor is no longer liable for any of the debts that were reduced or exempted in accordance with the plan. The People’s Court ends the proceedings and the debtor will be discharged and can unsupervised continue business operations.\textsuperscript{276}

\textsuperscript{271} Article 89, 2006 EBL.  
\textsuperscript{272} Article 90, 2006 EBL.  
\textsuperscript{273} Article 91, 2006 EBL.  
\textsuperscript{274} Article 92, 2006 EBL.  
\textsuperscript{275} Article 93, 2006 EBL.  
\textsuperscript{276} Article 94, 2006 EBL.
The notion of “Debtor in Possession” financing is new under the EBL. It has the possibility of facilitating a debtor to borrow money from banks and other potential lenders using assets that are non-encumbered by existing security agreements to secure a post-petition loan.\textsuperscript{277} If this financing is used to make payments for wages and other social welfare claims of employees during the period of the reorganisation, the financier of this loan will then rank ahead of other existing creditors, except that of secured creditors. As a result, this gives banks a small incentive to lend to financially distressed enterprises, but it does not provide a super-priority status.\textsuperscript{278} However, it must be noted that Shi points out that there is some ambiguity regarding the ability to ‘leap-frog’ over other creditors; thus more detailed rules and regulations in this matter are needed.\textsuperscript{279}

Overall, Chinese banks are unwilling to advance loans to troubled firms. A survey indicated that nearly 90 per cent of medium and small-sized enterprises face problems in receiving loans from state banks, so the prospects of receiving loans are extremely limited.\textsuperscript{280} Post-commencement finance is needed as the business must continue to pay for crucial supplies of goods and services including wages, rent, insurance, maintenance of contracts and other operating expenses as well as costs associated with maintaining the value of assets.\textsuperscript{281}

\textsuperscript{277} Rebecca Parry and Haizheng Zhang, ‘China’s New Corporate Rescue Laws: Perspectives and Principles’ (2008) 8(1) Journal of Corporate Law Studies 113, 135; Article 75, 2006 EBL.
3.7 Cross-Border Insolvency Issues

3.7.1 Development of a Cross-Border Insolvency Law

During the period in which China transformed itself into a socialist market economy, there has been global growth of cross-border insolvencies derived from the massive increase of global commerce. National laws and international agreements have been implemented and enacted to deal with these complex issues. China is not immune to these issues, as the global integration of its economy will, no doubt, play a central role in the shaping of the future world economy. In recent years, there has been world wide growth of cross-border bankruptcies as a result of the increasing integration of the global economy.

China was devoid of a national legislation regarding the acceptance of cross-border bankruptcies until the 2006 EBL. Prior to the 2000 draft of the new EBL, it was not regarded as a key issue, as the provisions regarding foreign proceedings were addressed in the 1991 Civil Procedure Law and they were assumed to be effective in dealing with these issues.²⁸² In a previous draft of the EBL, there was one sentence that ‘simply mentioned that the bankruptcy proceedings initiated in foreign jurisdictions shall have no effect on the debtor’s assets located in China, while the neglecting effect of bankruptcy proceeding commenced by Chinese Courts on the debtor’s assets located outside of the territory of China’.²⁸³ The lack of forethought to address these issues contributed to a lack of understanding of the complex issues relating to cross-border bankruptcies.

²⁸³ Ibid.
Pressure was placed upon legislators to address this complex issue. Several cases indicated that there were inconsistent attitudes held by different Chinese Courts regarding how to proceed with cross-border issues. In addition, as a result of the failure of the Guangdong International Trust & Investment Corporation — which involved the largest amount of assets and foreign debts in China’s history — international organisations such as UNCITRAL, World Bank, OECD, European Union, Asian Development Bank placed emphasis on the development of internationally recognised standards for cross-border insolvencies during the late 1990s. These issues resulted in discussions on addressing the issues of cross-border insolvencies.\(^{284}\)

The 2006 EBL has made provisions for the acceptance of cross-border insolvencies within the new law. It provides in Article 5 that:

\begin{quote}
The bankruptcy proceedings initiated in accordance with the provisions of this Law shall have an effect on the debtor’s property beyond the territory of the People’s Republic of China. Where an application or request is made to the People’s Court of recognition or enforcement of a legally effective judgment or written order of a bankruptcy case made by a foreign Court, in which the debtor’s property within the territory of the People’s Republic of China is involved, the People’s Court shall, in accordance with the international treaties concluded or acceded to by the People’s Republic of China or with the principle or reciprocity, examine the judgment or written order and make an order to recognize and enforce it, provided that the said judgment or written order does not contradict the basic principles of the law of the People's Republic of China, nor violates State sovereignty, security and social and public interests of the country, and nor infringes upon the lawful rights and interests of the creditor within the territory of the People’s Republic of China.\(^{285}\)
\end{quote}

This is the adoption of the ‘universality approach’ as to the effect on outbound proceedings. As Shi writes:

\begin{quote}
It is a significant step to assert the extraterritoriality of bankruptcy proceedings commenced by Chinese Courts, which provides the
\end{quote}

\(^{284}\) Ibid, 676.

\(^{285}\) Article 5, 2006 EBL.
administrator with a basis to pursue the debtor’s assets located outside the territory of China. However, it shall be emphasized that the final realisation of this extraterritoriality relies largely, if not completely, upon the cooperation from relevant foreign Courts. In addition, further details shall be fleshed out in order to facilitate this pursuit and the cooperation between Chinese Courts and foreign counterparts.\(^{286}\)

The outbound aspect of the universality approach is that Article 5 of the 2006 EBL gives binding effect on debtors’ assets located outside of China.\(^{287}\) The assertion of the extraterritorial effect of Chinese bankruptcy proceedings opened by Chinese courts is a significant step which provides the bankruptcy administrator the legal foundation to pursue the debtor’s assets outside of China. It is, however, important to note that the enforcement of this extraterritorial effect relies upon co-operation from foreign courts. Additional details must be fleshed out between Chinese and foreign courts in order for Chinese and foreign counterparts to attack debtor’s assets in different jurisdictions.

The inbound effect of foreign bankruptcy proceedings in China is also provided for in Article 5.\(^{288}\) Where a foreign court makes a judgment or decision in a foreign bankruptcy case, the Chinese court is to scrutinize the case in accordance with international treaties to which China is a party or by reference to reciprocity principles. The Chinese court shall not recognize and enforce the foreign judgment if it is found to be contrary to the basic principles of Chinese laws or impairs sovereignty, national security and public interests as well as the legitimate rights and interests of Chinese creditors.\(^{289}\)

In conclusion, the one article in the EBL is far from adequate for regulation of cross-border bankruptcy issues in China. In the following section, these international issues

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\(^{287}\) Article 5(1), 2006 EBL.

\(^{288}\) Article 5(2), 2006 EBL.

will be further discussed in detail. It is imperative that China, promulgate more detailed rules for its courts. China should embrace current internationally recognized rules, such as the UNCITRAL Model Law on Cross-Border Insolvencies to clarify the implementation of Article 5.

3.7.2 UNCITRAL Model Law

The UNCITRAL Model Law and its provisions in addressing issues on cross-border insolvencies is vital if the EBL is to be recognised internationally.290 The goal of the UNCITRAL Model Law is to assist states to manage transnational insolvency cases in an efficient, fair and cost-effective manner. In its simplest form, a transnational insolvency involves an insolvency proceeding in one country, with creditors located in at least one additional country. In the most complex case, it involves multiple proceedings, subsidiaries, affiliated entities, assets, operations and creditors in dozens of nations.291

The Model Law does not attempt to harmonise insolvency laws, but rather it aims to standardise the recognition of foreign proceedings, coordination or proceedings concerning the same debtor, rights of foreign creditors, rights and duties of foreign insolvency representatives, and cooperation between authorities in different nation states.292

In the implementation process of the Model Law, China has elected to implement and give recognition to foreign proceedings through one simple article embedded within the

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292 Ibid.
EBL. In other countries, there has been substantially more legislation implemented to
deal with the complex issues involved; Shi further notes:

China, sooner or later, should hammer out more detailed rules for its
courts to effectively participate in international co-operation. To this
end, it is strongly recommended that consideration should be given to
the UNCITRAL Model Law on Cross-Border Insolvency and the
European Regulation on Insolvency Proceedings, the two most salient
achievements in this field. China should use internationally-recognized
rules and practices in these international instruments as reference to
clarify the implementation of Article 5.293

Considering the Model Law, the following issues need to be addressed before
implementation: 1) scope of application; 2) reciprocity; 3) access of foreign
representatives and creditors to local Courts; 4) centre of main interests and
establishment; 5) recognition of a foreign proceeding and relief; 6) protection of creditors
and other interested parties; 7) communication and cooperation; and 8) concurrent
proceedings.294 The broad view that the drafters took in the recognition of foreign
bankruptcy proceedings is not clear and additional test cases and regulation will be
required before the full effects will be known. This matter is addressed further in section
6.1.2.

3.7.3 Cross-Border Recognition Issues with Hong Kong

Even though Hong Kong is part of China, the ability for courts to recognize each others
judgments is limited because of the ‘one country, two systems’ doctrine.295 Hong Kong
is a common law jurisdiction with its own separate legal systems and laws. It has not
enacted the UNCITRAL Model Law on Cross Border Insolvency that provides for
assistance and recognition to the foreign bankruptcy proceeding. Although there are
provisions for civil and commercial judgments to be recognised with the Mainland, this

294 UNCITRAL Model Law; See also Keith Yamauchi, ‘Should Reciprocity Be a Part of the UNCITRAL Model Cross-Border Insolvency Law’ (2007) 16 International Insolvency Review 145.
295 See generally, Randall Peerenboom, China’s Long March toward the Rule of Law (2002).
does not extend to insolvency matters, as the legislation will only apply where there is an express choice of jurisdiction clause.296

Hong Kong’s common law traditions have created the ability for Hong Kong to be flexible in recognition of foreign proceedings based on common law recognition principles.297 Foreign proceedings are those which meet the requirements of 1) apply to all the debtor’s assets (i.e. extraterritorial) and 2) treat all creditors fairly (i.e. non-discriminatory) the recognition will be available under Hong Kong common law principles.298 Professor Smart outlines different ways in which Hong Kong deals with the recognition a foreign proceeding:299

1) Where liquidation proceedings were held to meet the above criteria, even under the former law as was held in the GITIC case the proceedings will be recognised;300
2) If the same common law principles that apply to a formal restructuring under Mainland law as was found in Hong Kong Institute of Education v Aoki Corp (No2) then these proceedings will be recognised;301 and
3) Informal restructurings such as workout deals, the proceedings will not be recognised in the stay attachments of Hong Kong assets as the court held in Credit Lyonnais v SK Global Hong Kong Ltd.302

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297 For a general discussion of Hong Kong insolvency laws, see also, E. Tyler, ‘Insolvency Law in Hong Kong’ in Roman Tomasic (ed), Insolvency Law in East Asia (2006) 213.
298 Ibid.
Recognition does not deprive the Hong Kong court of jurisdiction to commence an insolvency proceeding against a Mainland corporation. A winding-up order may be made against a Chinese company under the Companies Ordinance as an ‘unregistered company’ if there is a ‘sufficient connection’ to Hong Kong. 303 There is a variety of case law that supports this proposition. 304 In Re Zhu Kuan Group 305 Barma J cited Banco Nacional de Cuba v Cosmos Trading Corporation 306 in which:

It was held that the making of a foreign winding up order against a foreign company with no assets within the jurisdiction and no trading connection, which was continuing to trade in its country of incorporation and elsewhere worldwide, was highly undesirable. I have no doubt that this is right. But in this case, I consider that there are assets within the jurisdiction, and that there is a trading or business connection with Hong Kong. 307

When there is a restructuring that is on-going in the country of incorporation, a scheme of arrangement may also take place in Hong Kong under section 166 of the Companies Ordinance. 308 Schemes of arrangement are also allowed in Hong Kong even without proceedings in the place of incorporation. 309

Recently there have been some significant divergences in common law cases as to how far recognition should be extended. 310 The Privy Council in Cambridge Gas Transport

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305 Re Zhu Kuan Group Co Ltd HCCW 873 (2003).
307 Ibid.
309 Sea Assets Ltd v PT Garuda Indonesia [2001] EWCA Civ 1696.
Corp v Official Committee of Unsecured Creditors of Navigator Holdings plc\textsuperscript{311} held that:

At common law, their Lordships think it is doubtful whether assistance could take the form of applying domestic system. But the domestic court must at least be able to provide assistance by doing whatever it could have done in the case of a domestic foreign insolvency. The purpose of recognition is to enable the foreign office holder or the creditors to avoid having to start parallel insolvency proceedings and to give them the remedies to which they would have been entitled if the equivalent proceedings had taken place in the domestic forum.

In The Convenience Container\textsuperscript{312} Waung J said in obiter:

I believe that it is a common feature of most liquidators in the world that in the absence of setting up parallel winding-ups (in foreign court and in local court), the local court prefers to protect local creditors (for obvious reasons) and the comity of nations (in the absence of international conventions on liquidations) is on the whole only given lip service. There is therefore every reason and good local sense for a local court (like the Hong Kong court) to prefer the local creditors (such as the plaintiffs here) over foreign creditors.\textsuperscript{313}

With respect, these comments are not good law (especially with the reference of ‘lip service’) and these views are contradicted by the recent decisions of CCIC Finance Ltd v Guangdong International Trust and Investment Corp and Hong Kong Institute of Education v Aoki.\textsuperscript{314}

The common law will no doubt continue to provide Hong Kong with guidance in the recognition of Chinese bankruptcy cases. With the absence of treaties to specifically deal with cross border bankruptcies (Hong Kong having not adopted the UNCITRAL model law), there will be issues of recognition and acceptance of foreign bankruptcy proceedings.


\textsuperscript{312} The Convenience Container [2006] 4 HKC.

\textsuperscript{313} Ibid.

\textsuperscript{314} CCIC Finance Ltd. V Guangdong International Trust & Investment Corporation [2001] HKCEA 774.
3.7.4 Cross-Border Recognition Issues with the United States

The Chinese economy is anticipated to overtake the US as the largest economy in the world within the next ten years.\textsuperscript{315} Trade between the two nations has quickly made them among the world’s top trading partners. This section will address in detail the issues surrounding the recognition of Chinese bankruptcy proceedings in US Courts and how they will be accepted.

The United States has implemented the UNCITRAL Model Law as Chapter 15 of the Bankruptcy Code. Chapter 15 is designed to coordinate United States proceedings with those insolvency courts in other jurisdictions around the world.\textsuperscript{316} Where the other country has not implemented the UNCITRAL Model Law, the common law principles take precedent and are discussed below.

The issue of ‘comity’ is an essential element to understand when dealing with recognition of international laws. The US Supreme Court in 1895 defined comity as ‘the recognition which one nation allows within its territory to the legislative executive or judicial acts of another nation, having due regard both to international duty and convenience, and to the rights of its citizens or of other persons who are under the protection of its laws’.\textsuperscript{317} Generally, comity may be granted where ‘it is shown that the foreign Court is a Court of competent jurisdiction, and the laws and public policy of the forum state and the rights of its residents will not be violated’.\textsuperscript{318} As long as the Court abides by ‘fundamental standards of procedural fairness’ granting comity is

\textsuperscript{317} Hilton v Guyot, 158 US 113 (1895) \\
\textsuperscript{318} Cunard Steam Ship Co. v Salen Reefer Services 773 F 3d 452 (1985)
appropriate.\textsuperscript{319} Specifically addressing issues of comity in bankruptcy proceedings, it was confirmed in the \textit{Cunard Case} that ‘American Courts have long recognised the particular need to extend comity to foreign bankruptcy proceedings’.\textsuperscript{320} Different states may have insolvency systems that differ from that of another and this was affirmed insofar as ‘nothing dictates that the foreign law be a carbon copy of our [United States] law’\textsuperscript{321} and ‘foreign proceedings need not be identical to those under the Bankruptcy Code’.\textsuperscript{322} ‘American Courts have consistently recognized the interests of foreign Courts in liquidating or winding up the affairs of their own domestic business entities.’\textsuperscript{323} Further, ‘the granting of comity to a foreign bankruptcy proceeding enables the assets of a debtor to be dispersed in an equitable, orderly, and systematic manner, rather than in a haphazard erratic or piecemeal fashion.’\textsuperscript{324}

There are essentially three different types of comity recognised by US Courts.\textsuperscript{325} These are: 1) Prescriptive Comity: the respect sovereign nations afford each other by limiting the reach of their laws;\textsuperscript{326} 2) Judicial Comity: the principle whereby Courts decline to exercise jurisdiction over matters appropriately adjudged elsewhere;\textsuperscript{327} and 3) Substantive Comity: requested recognition and/or enforcement in US Courts, of non-US or proceedings, or of non-US laws.

The affirmation of comity in a proceeding is an affirmative defence, whereas the denial of comity is within the Court’s discretion and can only be reversed by the Court when

\textsuperscript{319} Ibid.
\textsuperscript{321} Re Brierly 143 BR 151 (1992)
\textsuperscript{322} Linder Fund Inc. v Polly Peck International PLC 142 BR 807 (1992)
\textsuperscript{323} Cunard Steam Ship Co. v Salen Reefer Services 773 F 3d 452 (1985).
\textsuperscript{324} Ibid.
\textsuperscript{326} Hartford Fire Ins. v California 125 L.Ed 2d 612 (1993).
\textsuperscript{327} Hartford Fire Ins. v California 125 L.Ed 2d 612 (1993); re Spanish Cay Co. Ltd 161 BR 715 (1993).
there is an abuse of the discretion. In the case of *Allstate Life Insurance v Linter Group Limited*,\(^{328}\) The Court focused on several factors as indications of procedural fairness, in determining if an Australian insolvency proceeding warranted comity in a US court. In addressing these issues to determine if there is comity between the principles of US and Chinese law, the analysis of the Court will consider following factors from *Allstate Life Insurance v Linter Group Limited*:

1. **Whether creditors of the same class are treated equally in the distribution of assets.** Creditors of the bankrupt enterprise are to be treated equally depending upon their class in the distribution of assets. Distribution is made 1) to pay employees and related expenses; 2) social insurance contributions owed by the bankrupt; 3) taxes owed by the bankrupt; 4) secured creditors, and 5) non-secured creditors. If there is not enough to pay off all the unsecured claims, it shall be distributed pro rata amongst the unsecured creditors.\(^{329}\)

2. **Whether the liquidators are considered fiduciaries.** Liquidators and administrator are considered fiduciaries of the Court and required to be diligent and faithful in the performance of their duties.\(^{330}\) They perform their work in accordance within the provisions of the law, and report to the People’s Court, in addition to the creditors’ committee.\(^{331}\) The administrator is of a person who is held to a high professional standard such as a member of a professional body has not committed a crime and has no conflicts of interest in the case.\(^{332}\)

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\(^{328}\) *Allstate Life Insurance v Linter Group Limited* 994 F 2d 996 (1993).
\(^{329}\) Article 113, 2006 EBL.
\(^{330}\) Article 27, 2006 EBL.
\(^{331}\) Article 22, 2006 EBL.
\(^{332}\) Article 24, 2006 EBL.
3. Whether creditors have the right to submit claims that, if denied, can be submitted to a bankruptcy Court for adjudication. After receiving the materials for declaring a claim by creditors, the administrator examines the claims declared and compiles a detailed list.\textsuperscript{333} This list is presented to the first creditors’ meeting for examination and verification. When debtors and creditors have no objections to the claims recorded in the list, the People’s Court as a claim order confirms it. Where either a creditor or the debtor raises an objection to the claims recorded, the creditor may seek leave of the People’s Court that is hearing the bankruptcy application for adjudication.\textsuperscript{334}

4. Whether the liquidators are required to give notice to the debtors’ potential claimants. The liquidator or administrator are required to provide a complete detailed list of all claims and claim types at the creditors’ meeting, which is to be disclosed to all parties.\textsuperscript{335} Where a claimant fails to declare its claim in accordance with the law by not filing a claim with the administrator and the final distribution of assets has occurred, the claimant may not exercise a claim.\textsuperscript{336}

5. Whether there are provisions for creditors’ meetings. Chapter 7 of the EBL deals with provisions for a creditors’ meeting and creditors’ committees within the bankruptcy proceedings. The system involves a chairperson that is appointed by the People’s Court, selected from among the creditors with the right to vote.\textsuperscript{337} The creditors have the right to vote amongst themselves and exercise their power in determining the plan for bankruptcy and the procedure by which it is to take place.\textsuperscript{338} If at the creditors’ meeting, the creditors decide to establish a creditors’ committee, they may do so. This committee is to consist

\textsuperscript{333} Article 57, 2006 EBL.  
\textsuperscript{334} Article 58, 2006 EBL.  
\textsuperscript{335} Article 58, 2006 EBL.  
\textsuperscript{336} Article 56, 2006 EBL.  
\textsuperscript{337} Article 60, 2006 EBL.  
\textsuperscript{338} Article 61, 2006 EBL.
of representatives selected from the creditors, staff and workers of the debtor or a representative of a trade union. The creditors’ meeting has the power to supervise the administrator, distribution of property, convene meetings and other functions the creditors’ meetings allow it to complete. On the surface, it appears that this is a system that is efficient and effective and compares favourably with creditors’ meetings in other nations with a mature bankruptcy system.

6. Whether a foreign country’s insolvency laws favour its own citizens. As discussed throughout this thesis, the Chinese EBL is designed to be transparent, modern and able to deal with cross-border bankruptcies. Foreign judgments are recognised in China on the basis of reciprocity. However, foreign judgments contradict the basic principles of PRC law, violate state sovereignty, security, social and public interests of the country, and infringes upon the lawful rights of other creditors within the territory of China. In this instance, a state has the ability to favour its own nationals and laws over that of another country; however, this is a very common feature as all states reserve the right to preserve national interests, over that of other countries. This gives the EBL a more inward view that prefers the rights of the PRC and its creditors and debtors to that of foreign creditors. This is not in-line with the global trend to fully accept cross-border bankruptcies.

7. Whether all assets are marshalled before one body for centralised distribution.

There is no requirement for the assets of the debtor to be physically marshalled together in one location, as this would be logistically impossible in most instances. The administrator is the central entity that directs the liquidation of the company. All assets of the debtor are recovered and held within a stay of proceedings. The administrator is in

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339 Article 67, 2006 EBL.
340 Article 68, 2006 EBL.
341 Article 5, 2006 EBL.
charge of distribution in accordance with bankruptcy proceeding and in accordance with the law.

8. Whether there are provisions for an automatic stay and for the lifting of such stays to facilitate the centralisation of claims. There is provision for an automatic stay or suspension on all-civil and arbitration proceedings the debtor is involved in that have been commenced but not terminated. After the administrator takes control of the debtor’s assets, this stay is lifted and any civil law suits in which the debtor is involved in can be brought to the People’s Court that is hearing the bankruptcy case.342 This mechanism allows the centralisation of all civil claims against the debtor in the same court that the bankruptcy case is being held allowing complete control in one Court. This eliminates other courts making judgments that would adversely affect the rights of creditors.

3.8 Conciliation

There is an additional process separate from liquidation or reorganisation that allows a distressed debtor the ability to conciliate with their creditors for relief of debt or renegotiation of the term of loans and security, usually by a reduction of the debt by a certain percentage, change in payment schedules or other mechanisms used in offsetting debts such as debt-equity swaps. Conciliation, sometimes referred to as composition or settlement, is a process that has been available since the 1986 EBL; however, the process was not widely used in practice. The aim of conciliation is to avoid insolvent trading by the debtor.343 The pre-2006 practice mostly relied on the decisions of the relevant administration authorities in charge of the enterprise, rather than the enterprise itself. One of the foreseeable problems with this process was the absence of definitions set out in the

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342 Article 20, 2006 EBL.
legislation as to what conciliation entails.\textsuperscript{344} There were no guidelines or regulations provided by the Supreme People’s Court on this issue, it was largely left to Local Government officials to structure the agreement.

Under the 2006 EBL, the conciliation process is available to both bankrupt enterprises and those that are on the cusp of bankruptcy or in severe financial difficulty.\textsuperscript{345} The debtor is the only party that may file for the conciliation process.\textsuperscript{346} He or she may do this either after a bankruptcy proceeding has been initiated, but before the company is liquidated. Alternatively, the debtor can initiate the process without having a bankruptcy proceeding started, where the debtor is unable to pay a debt that is due.\textsuperscript{347} The goal of this process is for the debtor to resolve financial difficulties and continue its business operations, within the framework of a Court ordered agreement without the more complex bankruptcy reorganisation process.

The appointment of an administrator to oversee the process by the Court will be made at this time. However, this different approach to the typical debtor-in-possession style used in the US, or the appointment of an administrator to take control of the company such as that found in many Commonwealth nations. The new EBL combines these two approaches under a hybrid approach, pursuant to which the debtor may apply to the People’s Court for approval to administer his or her own assets and business affairs under the supervision of the administrator.\textsuperscript{348}

\begin{itemize}
\item \textsuperscript{344} Chen Jianfu, Chinese Law: Context and Transformation (2008) 558.
\item \textsuperscript{345} Article 7, 2006 EBL.
\item \textsuperscript{346} Article 95, 2006 EBL.
\item \textsuperscript{347} Article 7, 2006 EBL.
\end{itemize}
The conciliation process begins with the Court confirming that the proposed arrangement meets the provisions of the EBL and other relevant legislation. The Court will order a settlement, make a public announcement and convene the creditors’ meeting to discuss the draft settlement agreement.\(^{349}\) When the creditors’ meeting convenes, the creditors must adopt a resolution with a simple majority of the voting rights present at the meeting, and the claims represented by those creditors shall not be less than two-thirds of the total claims that are not secured by property.\(^{350}\) This process is mostly in the hands of the Court and the creditors as to the acceptance and passing of the resolution of the conciliation agreement.

Where the settlement agreement meets the minimum requirements for adoption by the creditors at the meeting, and the People’s Court approves such order, the Court issues an order that is to be made public and the conciliation procedures are terminated. The administrator hands over all property and business affairs back to the debtor and submits to the People’s Court a report on the case.\(^{351}\) In the event that the conciliation agreement is put to a vote by the creditors and fails to meet the simple majority and two-thirds of claims thresholds, or where the agreement fails to be recognised by the People’s Court, the Court makes an order for the termination of the proceedings and declares the debtor bankrupt under the EBL.\(^{352}\)

The conciliation agreement is binding on all creditors after it has been recognised by the People’s Court. A ‘creditor in composition’ is a person or company that has a claim that is not secured by property on the debtor, when the application for conciliation is made to the People’s Court. If a creditor fails to declare its claims in accordance with the proof of

\(^{349}\) Article 96, 2006 EBL.
\(^{350}\) Article 97, 2006 EBL.
\(^{351}\) Article 98, 2006 EBL.
\(^{352}\) Article 99, 2006 EBL.
debt forms, before the conciliation agreement is made, it cannot exercise any rights besides that of the conciliation agreement during the period of the agreement. However, the creditor may exercise its rights in accordance with the repayment conditions specified in the agreement, after the implementation of the conciliation agreement is completed.\textsuperscript{353}

The debtor has a legally binding agreement to pay off its debts to the creditors under the specified conditions set forth in the conciliation agreement.\textsuperscript{354} In the event that the debtor is unable or refuses to implement the agreement, a creditor may make application to the Court for an order of termination of the agreement, and declare the debtor bankrupt. In this event, the commitments made by a creditor in the conciliation agreement for adjustments of claims are revoked. Payments made to the creditor during the conciliation process are valid and deemed a credit of the bankrupt. Creditors that are part of the agreement shall not continue to receive additional payments until the amount disbursed to other creditors reaches the same proportion in the creditor class, thus alleviating any unfair treatment.\textsuperscript{355}

Unlike bankruptcy practice in many Western countries, the conciliation process may not be converted into a reorganisation process. This makes the decision of choosing the conciliation or reorganisation processes at the beginning a critical one. The reason for this legislative arrangement is said to be purely a consideration of procedural costs.\textsuperscript{356}

The exception is that after a bankruptcy proceeding is accepted by the People’s Court, if the debtor and all of the creditors reach an agreement of the disposition of the claims and debts, they may apply to the Court for an order to recognise such an agreement and for

\textsuperscript{353} Article 100, 2006 EBL.
\textsuperscript{354} Article 102, 2006 EBL.
\textsuperscript{355} Article 104, 2006 EBL.
\textsuperscript{356} Chen Jianfu Chinese Law: Context and Transformation (2008) 559; as translated from An & Wu (eds) A Practical Text on Enterprise Bankruptcy Law, 79
the termination of the bankruptcy proceedings. However, this requires 100 per cent participation from all parties in the agreement.

The conciliation process remains a viable option for bankrupt companies or those on the verge of bankruptcy. The framework allows an excellent method of restructuring the company in order to preserve value that would otherwise be lost in a liquidation scenario.

3.9 Chapter Conclusion

Chapter 3 has provided a comprehensive analysis of the EBL. The implementation of a ‘made in China’ law has provided a law that is designed to bring China into line with modern bankruptcy regimes capable of dealing with the fast changing pace of globalisation. In Chapter 4, a review of selected case studies will provide further understanding of endogenous problems faced in China and issues with regard to implementation of law and regulation.

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357 Article 105, 2006 EBL.
4. CASE STUDIES

4.1 Criteria for Selection of Cases Studies

Ideally, an analysis of a wide range of bankruptcy cases within China would have generated a set of data with a wide scope and various conclusions could be drawn. It is not feasible to do this: information from the Courts is difficult to obtain and in many instances not available to the public. Further, Chinese judgments are typically very short and provide no insight as to the reasoning why a decision was made. There is also the language barrier. Decisions, if available, would have to be translated from Chinese and the associated time and cost is prohibitive.

These cases selected in this chapter have all been decided within the past ten years. Information was derived from the mainstream press in China, Hong Kong and the USA, conversations with bankruptcy lawyers and administrators that had industry knowledge of the cases, industry forums where information has been shared, journal articles that refer to the cases, and, personal discussions with academics who had knowledge of the cases.358

These case studies will assist in our understanding of problems with the current business framework, law and regulation in China. The issues identified in these cases will be further considered in Chapters 5 and 6 where problems and solutions will be discussed.

4.2 Case Studies of Chinese Companies and Bankruptcy

4.2.1 B&T Case

The *B&T Case* is thought to be the first case in which a PRC Court formally and explicitly recognised the validity of a foreign bankruptcy.\(^{359}\) In this case, an application was made for recognition of an Italian bankruptcy proceeding in a Foshan People’s Court seeking recognition of the foreign judgment. The basis on which the application was made relied on Articles 267 and 268 of the then current Civil Procedure Law and the treaty between Italy and China which addressed judicial assistance in civil matters resulting from commercial dealings.\(^{360}\) Among these dealings was the agreement that the Courts would grant mutual recognition of judgments in civil cases, and there would be enforcement of the judgment in the other country. It is important to note that the combination of the Civil Procedure Law and the existing treaty between Italy and China provided the basis for the Court to enforce this foreign judgment. It would have been substantially more difficult for a Court to recognise the foreign judgment if there was not a treaty or other legal mechanism in place as the foreign applicant would not have legal standing to apply to the Court.

There is limited information on this case that is over ten years old; however, the principles of the recognition of a foreign bankruptcy proceeding was recognised in China. Having a treaty in place was the most crucial aspect of this case as it provided the

\(^{359}\) B&T Ceramic Group srl (B&T) filed a petition on 18 December 2000 applying for the recognition and enforcement of the following: 1) No 62673 Bankruptcy Judgment which declared EN Group spa bankrupt by the Milan Court on 24 October 1997; 2) Adjudication order on the transfer of confiscated assets made by the Civil and Penal Court in Milan on 30 September 1999; 3) The whole assets of the bankrupt including the 98% share in Nanhai Nassetti Pioneer Ceramic Machine Col Ltd be delivered to B&T; and 4) Confirming that B&T holds the 98% share of Nanha Nassetti; See especially, Jingxia Shi, ‘Recent Developments in Chinese Cross-Border Insolvencies’ (2002) 15 Australian Journal of Corporate Law 35; Jingxai Shi, ‘Cross-border Insolvency’ in Rebecca Parry, Yongqian Xu, and Haizheng Zhang (eds) China’s New Enterprise Bankruptcy Law: Context, Interpretation and Application (2010) 323, 329-333.

legal framework for the recognition of a foreign proceeding in China. This was one of the lead cases that later provided guidance for cases such as the *GITIC Case*, as it was one of the first publicised cases involving recognition of cross-border bankruptcy proceedings.

### 4.2.2 Guangdon International Trust and Investment Corporation (GITIC)

In 1981, the PRC government established the China International Trust and Investment Corporation (CITIC) to attract foreign investment for economic development into China. There was an aura of safety about making investments into this corporation, as it was believed that the Chinese Government backed the investments.\(^{361}\) After the successful establishment of CITIC, the Guangdon provincial government established GITIC as the provincially based arm for international investment within the province.

Beginning in 1997, the Asian Financial Crisis swept throughout Southeast Asia and affected many parts of the region. With slowing GDP and economic growth, GITIC began to have liquidity problems. This was the beginning of what would be the largest bankruptcy in the history of China with total liabilities of RMB 36.165 billion.\(^{362}\) This was also the first time that the 1986 EBL was used in the insolvency of a major financial institution or for a debtor with significant foreign liabilities.\(^{363}\)

Beginning in October 1998, GITIC was shut down by the Central Government and on 6 October 1998, CITIC announced that ‘overseas liabilities registered with the foreign exchange administration authorities and the legal principal and interest of deposits of


\(^{363}\) Ibid.
domestic natural persons shall have priority for repayment’. There were substantial promises made by provincial leaders to foreign bankers that they would stand behind the loans made to the trust company; however, the Central Government officials overruled the provincial authorities and on 16 January 1999, GITIC declared bankruptcy.

This decision marked the beginning of a new era of investing in China as up until then it was mostly based on guanxi relationships. The deciding factor for foreign investment had often been linked to high-level government officials with connections into the upper echelons on the Communist Party, not the project itself. A Hong Kong financial analyst mentioned that:

The only way you educate people is to have them burned. Unfortunately, that’s the free-market way to resolve the issue. Forcing GITIC into bankruptcy will be good for the Chinese financial system in the long run because it will force both Chinese financial institutions and foreign lenders to understand that borrowing must be based on commercial criteria, not connections. Both borrowers and lenders should not have a mistaken assumption about implicit government guarantees.

At the first meeting of creditors, the liquidation committee announced that RMB 36.165 billion in debt exceeded the assets by a shortfall of RMB 14.694 billion. Foreign creditors were relying on the practice of the unwritten policies of foreign creditors being paid out in full; however, the implementation of Article 37 of the 1986 EBL provided that the order of priority of a State-Owned Enterprise was wages, labour insurance, taxes

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364 Ibid.
365 For a discussion on guanxi, see footnote 436.
367 Ibid.
and then unsecured creditors. The 1986 EBL did not have any provisions for priority of payment to foreign creditors.

The PRC proceedings in GITIC was recognised by a Hong Kong Court in 2001, another milestone in the recognition of cross-border bankruptcies. This was first time that a Chinese bankruptcy proceeding was recognised in another jurisdiction. The case took place in the Hong Kong High Court between CCIC Finance Ltd (CCIC) and GITIC Hong Kong Ltd. (GITIC HK) where CCIC was seeking a garnishee order against the assets of GITIC HK based on a loan agreement. CCIC filed a proof of debt with the administrators of GITIC for US$35 million basing this on a Letter of Support previously provided by GITIC. The liquidator turned down the claim noting that the Letter of Support failed to state with certainty the acts required to be performed by GITIC and the rights and obligations that were to be preformed and thus did not provide a guarantee within the meaning of PRC law. CCIC later sued GITIC in a Hong Kong Court seeking ‘monies due’ and received default judgment as GITIC did not respond to this lawsuit. A Hong Kong Court then granted a garnishee order attaching ‘all debts due or accruing due from GITIC HK to GITIC’. Eventually, the case found its way to the Hong Kong High Court, which dealt with the issues of: 1) the liquidation of GITIC HK; 2) the bankruptcy of GITIC in the PRC; 3) the conduct of CCIC; and 4) other additional

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372 Ibid, 10.
373 Ibid, 11.
374 Ibid, 14.
matters. In submissions to the Court, the applicant sought preference is granted to one creditor over that of another, thus interfering with the fundamental principle of Hong Kong bankruptcy and liquidation law that a creditor should never be allowed to exploit the judicial process to achieve an unfair advantage over the general body of creditors. The High Court applied *Prichard v Westminster Bank Ltd* in which the English Court of Appeal was asked to overturn a garnishee order made in favour of one of the creditors of a bankrupt estate. Lord Denning said in his judgment of *Prichard v Westminster Bank Ltd*:

The general principle, when there is no insolvency, is that the person who gets in first gets the fruit of his diligence. But it is different when the estate is insolvent. The result is that at the date of death, a curtain comes down. All debts existing at that day are to be paid *pari passu*. The executors must pay all the creditors equally and rateably.

In applying the principles of private international law, the Hong Kong Court applied the principle that when there is a pending process of universal distribution of a bankrupt’s effects in a foreign jurisdiction, the foreign local Courts should not allow steps to be taken within its jurisdiction that would interfere with that process. The Court cited Lord Dunedin in *Galbraith v Grimshaw*, stating:

So far as the general principle is concerned it is quite consistent with the comity of nations that it should be a rule of international law that if the Court finds that there is already pending process of universal distribution of a bankrupt’s effects it should not allow steps to be taken in its territory which would interfere with the process of universal distribution.

These principles highlighted the need to examine the nature of the winding up of GITIC in the PRC and in particular whether that liquidation had an extraterritorial effect. The

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376 Ibid, 48.
determination needed to be made if the 1986 EBL intended or purported to apply to the extra-territorial assets of GITIC.\(^\text{379}\)

The Court refused the application for the garnishment based on the ‘primary reason that the GITIC liquidation is being pursued on the basis of a universal collection and distribution of assets and the creditor’s world-wide are to be paid \textit{pari passu} with each other subject only to ranking.’\(^\text{380}\) Justice Gill further noted that:

\begin{quote}
The concept of comity of nations is not of itself a reason to turn away a litigant with a bona fide claim that should otherwise be granted on the merits. But where a foreign jurisdiction is actively and openly pursuing a liquidation in which it says it intends to treat all creditors, domestic and foreign, alike, and then patently does so, it is not, I believe, for the Courts of Hong Kong to interfere with that process. \(^\text{381}\)
\end{quote}

As a result of this case, a PRC proceeding was recognised in a foreign jurisdiction and this became a landmark for the process of bankruptcy law within China.

\subsection*{4.2.3 FerroChina}

FerroChina was a recent victim of the global financial crisis, and is thought to be one of the first real tests of the new EBL. Steelmakers in China have been struggling with the global slowdown in manufacturing, and FerroChina suspended production of steel on 9 October 2008 when it was unable to repay a RMB 706 million loan.\(^\text{382}\) Management implemented a corporate rescue plan and a restructuring plan was initiated. By 29 October 2008, it was facing 169 lawsuits lodged by creditors and suppliers in Chinese

\begin{flushright}
\textsuperscript{379} CICC Finance Ltd v Guangdong International Trust & Investment Corporation Hong Kong High Court, HCA 15651/1999, 31 July 2001, 60.
\textsuperscript{380} Ibid, 96.
\textsuperscript{381} Ibid, 101.
\end{flushright}
Ten months later, a restructuring plan had been accepted at a creditors’ meeting, which would see China Minmetals Corporation acquiring five of the six operating subsidiaries of FerroChina for RMB 3.2 billion. The distribution to creditors depends on the class of the debt that was owed by FerroChina, divided between onshore debt and offshore debts. In the initial agreement, the secured portion of the onshore debt’s was to be paid out at 60 cents on the dollar, while the holders of onshore unsecured debt’s will receive approximately 20 per cent of the debts face value. People that were familiar with the agreement said ‘it is fair because the cuts to foreign investors with onshore claims are the same as those taken by mainland banks holding FerroChina Debt.’ A group of foreign bondholders holding US$130 million in outstanding bonds were completely left out of the restructuring, as that class debt was not considered in the restructuring agreement.

In structuring the purchase of FerroChina by China Minmetals, the purchase essentially pays for itself. Creditors are to be paid out over time. They can elect to be paid out sooner but there would be a very substantial discount taken on the payments to the creditor. It is estimated that the entire purchase price will be paid from cash-flow generated within the first five years of the acquisition, essentially costing China Minmetals nothing.

In this case, it is apparent that the bankruptcy law allowed a fire sale of the company to a competitor, while keeping the factories running, albeit at a lower rate than before. The liquidation procedures under the EBL seemed to work and some of the creditors will be

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383 Ibid.
385 Ibid.
386 Ibid.
387 Personal Conversation with Hong Kong-based bankruptcy lawyers (Hong Kong, 16 October 2009).
receiving a disbursement in accordance with the agreement to purchase the company. Note the dominant position and influence of China Minmetals had over FerroChina in this case. The ability to make such a purchase and the structuring of the payments to creditors over time, paid for out of earnings, indicates that China Minmetals had superior power in this case and directed it as they saw fit. It is quite likely that government officials used their influence to achieve this outcome.

4.2.4 Monkey King Group

The Monkey King Group case is an example of corruption and insolvency fraud in China. According to reports in 2001, the Huarong Asset Management Corporation (the group’s second largest creditor), local governments and the Monkey King Group cooperated in carrying out a strategic bankruptcy in violation of the then current 1986 EBL.388

The Monkey King Group was a large business conglomerate in the city of Yichang City in Hubei Province. It was established in the mid-1990s through the merger of medium and large SOEs with a registered capital of RMB 580 million. It was a holding company with a number of subsidiaries, including the Monkey King Stock, a listed company with 110,000 shareholders. After foundation of the group, the financial status of the company was poor. It had borrowed a large amount of money with high interest, gambled in investments in listed companies, accumulated losses reaching RMB 2.5 billion at the end of 2000 and was the defendant in 232 civil litigation cases totalling RMB 1.4 billion.389

389 Wang Weiguo, ‘Bankruptcy Law’ (Lecture presented at La Trobe University, Melbourne, 19 January 2006).
The Monkey King Group applied for bankruptcy in February 2001. Prior to filing for bankruptcy, the group transferred assets out to other companies without notifying shareholders beforehand. The assets dropped from RMB 3.4 billion at the end of 1999 to RMB 370 million in February 2001. There were losses from the operations of approximately RMB1 billion during this time, resulting in RMB 2 billion that had been transferred out of the company in the previous two months of the bankruptcy filing.  

Some local government officials admitted that the city had taken over assets from the group starting in August 2000. It was estimated that 11 subsidiary companies with RMB 642 million in assets were peeled off, including 6 with no compensation. An additional RMB 490 million in other companies’ shares were transferred out of the companies books.

This case highlights the importance of an insolvency law with the ability to prosecute individuals or enterprises engaged in insolvency fraud. Several problems brought to light by this case found their way into the drafting of the 2006 EBL. These included: 1) Restriction on pre-petition transactions, especially those among related companies; 2) Investigation as a special function and procedure stipulated in bankruptcy law; 3) Administrator or liquidator responsible for the investigation of the company; 4) Strict norms and liabilities on director’s duty of information disclosure; and 5) Sanctions for fraudulent conduct, including declaration of discredit, disqualification as a director, fines, jail, etc.

390 Ibid.  
392 Wang Weiguo, ‘Bankruptcy Law’ (Lecture presented at La Trobe University, Melbourne, 19 January 2006).  
393 Ibid.
It is important to note that the fraud in the Monkey King Case was perpetrated on various levels, including that of the local government. It is less likely that a similar situation would happen today under the new 2006 EBL, however, there still is a possibility for insolvency fraud to be committed.

4.2.5 Asia Aluminium

Asia Aluminium was the region’s largest processor of aluminium metal products used in the packaging, construction materials and printing industries. It became a victim of the GFC as it suffered from the credit crunch, a 20 per cent drop in sales volume and an increase of 29 per cent in production costs.³⁹⁴ This is a unique bankruptcy case, as it is a Chinese-based company that had a very elaborate share and foreign investment structure through Bermuda and Hong Kong-based companies. The bankruptcy took place in the Hong Kong Courts and administrators were appointed in Bermuda and Hong Kong.

Asia Aluminium and its associated group companies had its mainland operations based in the industrial city Zhaoqing in the Province of Guangdong. It produced aluminium extrusion, rolled products, design, surface-finish and fabrication services for both domestic and overseas customers. Its customers were mainly in the construction, infrastructure, industrial, home building and improvement and transportation industries.³⁹⁵ The group was constructing a new rolled product facility with a capacity of 400,000 tonnes once complete for an estimated cost of US$265 million, thus doubling the total output of the group’s aluminium products.³⁹⁶ The former holding company of

³⁹⁴ Eric Ng, Wong Ka-Chun and Jasmine Wang, ‘Asia Aluminum, parent offers to buy back bonds’, South China Morning Post Hong Kong, 14 February 2009.
³⁹⁶ Ibid.
the group was a listed company on the Hong Kong Stock Exchange. In 2006, it was privatised through a special purpose vehicle, AA Investments Company Limited (Bermuda) that offered two sets of PIK notes for US$535 million. This type of transaction is commonly known as a pre-IPO.\textsuperscript{397} In addition, Asia Aluminium Holdings Limited (Bermuda), a wholly owned subsidiary of AA Investment Company Limited, had US$450 million in Senior Notes that were offered through an Indenture in December 2004 and were listed on the Singapore Exchange.\textsuperscript{398} The group’s financial position (large debt loads and the unavailability of additional funding due to the Global Financial Crisis) resulted in the group being unable to secure financing for construction of the new facility.

In order to continue operations, AA Investments and AA Holdings announced a tender offer on 13 February 2009 to acquire all the PIK Notes and Senior Notes at a discount.\textsuperscript{399} If successful, this offer would have allowed the group to lower the entire debt load and obtain further financing to continue operations.\textsuperscript{400} The buyback of 100 per cent of the PIK notes and 90 per cent of the Senior Notes were at a minimum discount of 72.5 per cent of the current trading prices.\textsuperscript{401} The bondholders did not accept the tender offer, and the PRC Municipal Government that was supporting the financing of the buyback, withdrew their support of the tender offer on 16 March 2009. During the lead-up to this event, various senior management of the company resigned and there were incidents of unrest by the workers in the industrial complex.\textsuperscript{402}

\textsuperscript{397} For further discussion of pre-IPO’s, see Section 5.1.4.
\textsuperscript{398} Ibid.
\textsuperscript{399} Payment-In-Kind Notes are a very high interest debt based security, but give investors very little rights when a company fails.
\textsuperscript{400} Ibid.
\textsuperscript{401} Eric Ng, Wong Ka-Chun and Jasmine Wang, ‘Asia Aluminum, parent offers to buy back bonds’, South China Morning Post Hong Kong, 14 February 2009.
The foreign bondholders, fearing a collapse of the company, moved to install provisional administrators of Asia Aluminium Holdings Ltd. by way of an *ex parte* summons. By applying for this application in Hong Kong, the summons encompassed the entire group of companies as the group structure of companies was such that the Chinese companies were controlled by Hong Kong Companies that were in turn controlled by BVI companies that were controlled by Asia Aluminium Holdings. These types of complex corporate structures are quite common with Chinese companies that have received foreign investment by means of debt or equity from outside of China, especially where there are public listings on stock exchanges or debt offerings by way of bonds in either American, Hong Kong or Singapore debt markets.

The provisional liquidators were then tasked with searching for a suitable buyer for the company and two creditable companies came forth. A group of hedge funds that were holding PIK notes solicited Norsk Hydro, a Norwegian based firm that had a similar business in Europe, and began discussions in the hope of rescuing the company with a foreign investment. However, they were never given permission from Asia Aluminium’s management to view the books or visit its factories. Norsk Hydro withdrew its interest in the company, leaving the existing Asia Aluminium management team offer to buy the firm for US$475 million as the only viable deal on the table.

On 25 June 2009, a Hong Kong Court ruled that the firm could be sold back to its management team for US$475 million. The distribution to creditors would see nearly a full repayment of US$350 million to PRC banks, and a 20 per cent distribution to

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403 Asia Aluminum Holdings Ltd. HCCW 140/2009.  
404 Individual discussions with Hong Kong-based bankruptcy lawyers (Hong Kong, 16 October 2009).  
405 Naomi Rovnick ‘Norsk Hydro withdraws offer for Asia Aluminium’ South China Morning Post Hong Kong, 24 June 2009.
Bondholders who were owed US$450 million.\(^{406}\) The PIK note holders would see return of around one cent on the dollar, as this type of investment is of high risk and has low rights, as discussed further in section 5.1.4.

There was a great deal of scepticism on the completion of the management buyout. It was rumoured that the interest from Norsk Hydro was unwelcome to the company and local government officials. There was fierce resistance from Asia Aluminium’s Chairman, Kwon Wui-Chun, who was quoted in Chinese newspaper as saying the company ‘absolutely cannot be sold to foreigners’.\(^{407}\) The local government claimed that it needed a quick deal for Asia Aluminium in order to ensure the social stability of the workers and to placate upset creditors who were protesting and blockading the plant. Zhaoqing’s Foreign Trade and Investment Committee outlined its resistance to the Norsk Hydro bid on 19 June 2009 in a letter to the company’s creditors. It was noted that ‘this kind of expression of interest will only cause delay in the restructuring process’.\(^{408}\) A leading distressed debt hedge fund principal said that ‘this ridicules any sense of trust in doing business in China … This case would have been a great opportunity for a restructuring to work in an open and transparent manner.’\(^{409}\)

The result of the management buyout is that the original management group was able to retain control of the company and almost all-foreign investment was stripped from the company. The complex structure of the Hong Kong, Bermuda, and BVI companies were still in place, as they would have value in the future if the company were to seek foreign

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\(^{406}\) Ibid.  
\(^{408}\) Naomi Rovnick ‘Investors lose battle for Asia Aluminium’ South China Morning Post Hong Kong 26 June 2009.  
\(^{409}\) Ibid.
investment again. At the end of the day, it was an extremely beneficial deal for management, accomplishing a better than expected result of the management buyback that was originally offered. The larger underlying problem is the protection of debt holders in pre-IPO company structures, as discussed in section 5.1.4.

There is some recent fallout from the bankruptcy of Asia Aluminum. The former chairman and chief executive are accused of funnelling cash into a shell company in which they had interests in the three months before they announced that Asia Aluminum was in trouble. Creditors are now seeking to recover RMB 345 million resulting from this fraudulent transaction.

4.2.6 East Star Airlines

East Star Airlines was a privately owned airline based out of Wuhan Tiahe International Airport, where it serviced ten routes. It started flight operations in 2006. It was one of the first privately owned airlines in China and was the first private airline allowed to operate international flights. Despite operating ten aircraft and appearing to be successful, the downturn in the economy as a result of the GFC and high debt loads placed the company in bankruptcy. The Wuhan Intermediate People’s Court accepted the case for bankruptcy on 30 March 2009. This action was a result of the grounding of the airline on 15 March 2009 by China Aviation Administration when it suspended its operating license. This order came after GE Aviation Financial Services, the leasing company for the aircraft, sought redress from the Wuhan government after repeated requests to the company for unpaid aircraft leasing fees, with no response from the

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410 Personal Discussion with Hong Kong-based bankruptcy lawyers (Hong Kong, 16 October 2009).
411 Naomi Rovnick ‘Asia Aluminium’s former top two sued over cash’ South China Morning Post Hong Kong, 17 March 2009, B3.
company. The China Aviation Administration said the ‘the main reason is due to the airline not being able to pay back its heavy debts, which has led to operational difficulties’.\footnote{China grounds debt-laden East Star Airlines (2009) Reuters UK <http://uk.reuters.com/article/idUKPED2162492009090315> at 17 November 2009.}

An inexperienced administrator from a local law firm was appointed by the Court to oversee the assets and to preserve whatever value of the company would be left for creditors of the company. On 11 August 2009, the ownership group of East Star Airlines and some private investors reached a cooperation agreement and developed a restructuring plan that could see the EBL Chapter 8 reorganisation process used to bring the company out of bankruptcy and continue as a going concern. On 27 September 2009, the Court sent a letter back to the group rejecting the restructuring plan as they determined that it was not feasible and directed the administrator to continue with the liquidation. The Court determined that for a successful restructuring program, although the group submitted a restructuring plan, there would be a need for investment of 2 to 3 billion RMB to be injected into East Star Airlines as equity. The funding sources failed to provide proof of financing, did not provide the creditors with proof that their claims would be satisfied, and the plan did not protect the existing creditors interests.\footnote{East Star Airlines Bankruptcy reorganization case, the dust has settled amazingly fast (2009) China Insol <http://www.chinainsol.org/show.aspx?id=341&cid=13> at 16 November 2009.} In short, the ownership group filed a reorganisation plan for the company; but, there was no proof of money to finance the deal. Submissions to the Court were based on loose principles and there were no definite guarantees or legally binding agreements that would have seen the reorganisation re-financed.\footnote{Individual discussion with Hong Kong-based bankruptcy lawyers (Hong Kong, 17 October 2009).}
On 16 November 2009, there was to be an auction of the physical assets of East Star Airlines, including marshalling equipment, machinery, spare parts, vehicles and consumables minus the aircraft repossessed by the creditor. No bidders attended the auction, as there was a requirement for a RMB 2 million deposit for bidding. It appears that the estimated value of the RMB 29 million asset pool was over-valued or there was no appetite in the marketplace for such equipment at the time. Recovery of any asset values will be at a fire sale of the assets, returning much less than originally anticipated.

It is submitted that the Court’s decision was correct as the proposed restructuring plan did not meet the requirements necessary for a successful reorganisation. It would not have solved the needs of the company and the creditors. Now the company is in the process of being liquidated with total creditor’s claims of RMB 5.863 billion with a foreign creditor, GE Aviation Financial Services, the financing company of the aircraft claiming RMB 2.4 billion. The resolution of the foreign creditor’s claims in this case is one of the most high profile in recent history and should provide some guidance for the future treatment of foreign creditors.

4.2.7 GBS Group S.p.A.

The Italian company GBS Group S.p.A. (GBS) is a company engaged in the production and sale of milling machines and equipment used in the production of grain and rice products. It was formally a family-run enterprise; however, in 2008 it became a victim of the GFC and was placed into extra-ordinary administration by the Italian Ministry for Economic Development, where currently several investors have registered their interests.

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in taking-over the company.\textsuperscript{417} GBS had a Wholly Owned Foreign Enterprise factory in Myun, China where it produced milling machines (GBS Beijing). In late 2008, GBS Beijing entered into an agreement with a Chinese purchaser for the purchase of 60 flour-milling machines for a net value of RMB 800 million. Under the contract, the Chinese purchaser forwarded RMB 300 million as a deposit, and was to receive a prototype test report following which additional payments were to be made. After initial deposit was forwarded, the Chinese purchaser was informed that GBS was in administration with the risk of liquidation, and GBS Beijing’s legal representative, directors and other senior management had been replaced. GBS then dismissed the majority of other mid-level managers and demanded that GBS Beijing to provide capital, production and accessories to support the parent company in Italy in order to keep it solvent. The serious events that happened to GBS Beijing made the Chinese purchaser very uncomfortable with the deal as they had invested RMB 300 million into products they had yet to receive. Another RMB 500 million payment was required for the fulfilment of the contract and the purchaser refused to honour the contract, as the terms of the agreement payment had not been fulfilled. Even though GBS Beijing is a separate legal entity, wholly separate from its parent company in Italy, there is still concern that if the Italian company goes into full liquidation, GBS Beijing would also be liquidated or sold to recoup the investment to its Italian parent. The Chinese purchaser is now relying on the Court to sever the contract, release them from their contractual obligations, and recover the RMB 300 million that they have paid to GBS Beijing.\textsuperscript{418}

This case presents a scenario in which the Chinese company has its own separate legal entity from that of its parent company in Italy, has not committed an act of bankruptcy


itself, but is pulled into a situation where contracts are to be broken based upon the
actions of its overseas parent company. Requesting that the Court terminate the contract
for a reason that is not force majeure and where there is no further reason for termination
of the agreement goes against the principles of contract law. The company, even if it
were in bankruptcy proceedings in China, would still have the legal obligation to perform
the contract.\footnote{419} If the contract included terms providing that if GBS Beijing or its parent
company committed an act of bankruptcy, there would be legal grounds for the
termination of the contract. However, no such wording was included in the agreement
and the contract stands. Professor Li has stated ‘that as an independent legal entity, GBS
Beijing should be independent according to law and enjoy civil rights and obligation.
GBS Group is only in the administration phase, and from the current point of view, it
should not affect GBS Beijing and it should be allowed to carry out its normal business
activities.’\footnote{420} As the GBS Group is currently being reorganised, the business can still
operate normally and the company can continue to be engaged in business activities.
There is a certain additional degree of risk in dealing with such company; however, with
proper risk management and due diligence, these risks can be reduced. At the time of
writing, it is not currently known what the People’s Court decided in this matter.

\textbf{4.2.8 Sanlu Group Share Limited Company}

The Sanlu Group case concerns the company, which was at the centre of the
contaminated milk powder scandal, which received international attention in 2008. It is
estimated that 300,000 children became sick with kidney problems and several died from
kidney failure directly related to the use of melamine-contaminated milk powder\footnote{421}.

\footnote{419}{Ibid.}
\footnote{420}{Ibid.}
\footnote{421}{Jim Yardley and David Barboza, Despite Warnings, China’s Regulators Failed to Stop Mile (2008)
Herald Tribune <http://www.heraldrum.com/article/20080927/ZNYT03/809270413/1006/SPORTS
?Title= Despite_Warnings__China__x2019_s_Regulators_Failed_to_Stop_Milk> at 27 March 2010.}
Sanlu and a variety of other milk powder producers added melamine, which is an organic chemical that artificially inflate the reading of protein levels in the powder, resulting in higher sale price.\textsuperscript{422}

The scandal first broke after New Zealand’s Fonterra Cooperative recalled all of its milk products that had Chinese milk powder as ingredients. Testing for melamine was not part of the standard protocol for quality assurance of milk powder, as regulators believed that it was not necessary, as they would not suspect a chemical like this would ever be added. The New Zealand government alerted the Chinese government to the problem in September 2008. It is estimated that indications of these problems started in late 2007 but were apparently not reported to the Sanlu board of directors until early August 2008.\textsuperscript{423} The global recall of milk products was reported in the global media and an international criticism was directed at China’s food safety laws.

Under the Consumer Protection Law, the role of accepting complaints and carrying out investigation and meditation is placed within the power of the China Consumer Association. In this case, there are reports that the association or its local regional counterparts did not assist consumers in their complaints. In September 2008, lawyers representing victims applied to the Ministry of Health and the China Consumer Association to contribute and participate in formulating a compensation plan. The silence of the consumer association in such a significant case strongly suggests that Chinese consumer advocates are more aware of their obligations to the government than

their duty to protect consumers. Similar reports state that both the local government and the media were aware of the issues and took no action, to avoid any potential scandal during the August 2008 Olympics being held in Beijing. Numerous lawsuits were assembled by victims for damages against Sanlu and 22 other companies involved in the scandal. Product liability cases and class-action lawsuits are extremely uncommon in China, as the Central government discourages the filing of lawsuits with multiple plaintiffs saying that they could disrupt social stability.

On 18 December 2008, the court in Shijiazhuang Intermediate Peoples Court received and accepted an application for the bankruptcy of the Sanlu Group made by Shijiazhuang Industrial and Commercial Bank. What is interesting about this case is that the day before the application for bankruptcy, the company received a loan for RMB 900 million that was to be paid into a compensation fund for victims affected by the tainted milk. As part of the compensation fund, families would receive RMB 200,000 for the death of a child, RMB 30,000 for children with serious illness such as kidney stones and RMB 2,000 for less severe cases. Since the bankruptcy application was accepted before any courts would accept a lawsuit, all litigation would be barred as an automatic stay of proceedings took place and the court denied all lawsuits against the company.

What is most interesting about this case is the high level of government interference in the case to produce a desired result. Firstly, the loan was made to Sanlu for the compensation fund the day before the bankruptcy application was made. It seems highly

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427 Ibid.
unlikely that a bank or other enterprise that was not directly controlled by the government would make such a loan for a substantial amount unless it was engineered this way by the government, especially as there is no way to pay back this loan. Secondly, Hebei National Trust and Investment acquired claims by common creditors of Sanlu for 20 per cent of the face value. This resulted in only a few creditors attending the creditor meeting, which consisted of state-owned banks and investment companies making the direction of such much easier.\textsuperscript{428} Thirdly, the Shijiazhuang court chose to appoint a liquidation committee made up of government officials to administer the bankruptcy, rather than an independent professional organization.\textsuperscript{429}

As a result of the government actions, the company was declared bankrupt and several company officials were ultimately convicted and harsh prison terms and fines were handed out, including two cases in which the death penalty was carried out.\textsuperscript{430}

The Sanlu case highlights significant issues that still exist in China relating to government interference in bankruptcy proceedings. The way in which local government and SOE’s can influence and avoid the application of the bankruptcy law is of concern as it goes against normal practice.\textsuperscript{431} China still bends the rules to do what it believes is proper and prudent.

4.3 Chapter Conclusions

The cases that were selected for study present a wide range of issues common throughout Chinese bankruptcies. Major problems relate to government interference in the bankruptcy proceedings, recognition of foreign proceedings, creditor’s rights, law not being followed as intended, misuse of the role of an administrator, pre-IPO problems, false bankruptcy, bankruptcy fraud and how bankruptcy cases had an effect on the change in law and regulation.

In Chapter Five these cases assist us in identifying endogenous issues of business in China. Chapter Six will look at specific problems with bankruptcy law and regulation.
5. ENDOGENOUS ISSUES: PROBLEMS AND SOLUTIONS

5.1 Endogenous Issues

A variety of problems arose with the implementation of the new bankruptcy regime in China. In Chapter 3, the academic analysis of the law and its associated legal problems were addressed. However, what the written law states is not always necessarily what happens in practice. In Chapter 4, case studies revealed a variety of different problems that have been encountered in practice. The purpose of Chapter 5 is to discuss what might be termed ‘endogenous’ or ‘systemic’ issues that affect the legal regime in the PRC.

Numerous books and articles have discussed the unique business environment in China.\(^{432}\) It is common knowledge that doing business in China is like nowhere else in the world. Special consideration must be made in structuring business transactions to protect the interests of the foreign party. This chapter will address some of these issues.

5.1.1 Problem One: Can a Chinese Court give a Fair and Impartial Judgment?

**Problem:** There has been a long-standing discussion among academics regarding the rule of law in China and the rule of law in the context of economic development.\(^ {433}\)

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\(^{433}\) For an in-depth analysis of the rule of law and rule of law and economic development, See also Randall Peerenboom, China’s Long March Toward Rule of Law (2002) Chapters 4 and 10; See also Kenneth Dam,
These various opinions concerning the rule of law in general will not be discussed here. Instead, only an analysis of actual application of the law with evidence from bankruptcy proceedings will be addressed.

**Analysis:** In bankruptcy proceedings there is a high degree of probability of interference from multiple sources, such as local government officials, banks, Ministry of Commerce, creditors, the debtor (and anyone else that could possibly have an interest in the proceedings). China appears to be working hard to improve the quality, fairness and rule of law in economic cases. There is a shift to the application of standard commercial principles of international private law and the upholding of these principles; however, one can never be too sure. With the accession to the WTO and the rapid revision of many new commercial laws, there is now a framework in place that has the ability to give more impartial judgment than ten or fifteen years ago.

**Solution:** The best strategy for most international investors and creditors is to avoid the Courts and attempt to settle the problem before a bankruptcy proceeding commences. By eliminating the use of the Courts and having the parties come to a commercial agreement there can be a higher level of certainty.\(^{434}\) The Chinese Courts do not exhibit judicial independence. Having a truly independent judiciary in a one-party political system may never be entirely possible.

\(^{434}\) Personal discussion with Hong Kong-based bankruptcy lawyers (Hong Kong, 15 October 2009); One-to-one discussion with Hong Kong-based Restructuring Professional (26 October 2009).
5.1.2 Problem Two: Undue Influence of Local Government and Officials

**Problem:** One of the major concerns for foreign and domestic creditors is the amount of influence that a high-ranking government official can have over a bankruptcy proceeding. Such personal connections have allowed senior officials and their children to monopolise key businesses and own substantial real estate holdings throughout China. The public perception is that such favouritism is a remnant of feudal times.435

**Analysis:** *Guanxi*436 has its roots in two matters: 1) Confucian principles required that people respect their elders and officials; and 2) a method of allocating scarce resources to the people in Chinese society.437 In the past, Chinese government officials were empowered to authorise or approve the granting or use of land and resources, access to energy, access to business opportunities and government procurement projects, and issuance of permits, licenses or concessions. Officials would allocate resources and opportunities to those who paid homage or gave something in return. Today, there are additional safeguards in place to regulate allocation and procurement processes including laws to counter corruption that often accompanies personal power that may be abused.438 With changes in laws and emphasis placed on economic responsibility and market constraints from the new market economy, the practice is not as widespread as it once was. Various scholars have found a diminishing role for *guanxi* in China’s urban industrial economy. However, this does not mean that the practice is gone for good.439

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436 *Guanxi* literally means “relationships” and stands for any type of relationship. In the Chinese business world, however, it is also understood as the network of relationships among various parties that cooperate together and support one another. In essence, this boils down to exchanging favours, which are expected to be done regularly and voluntarily.
437 Ibid, 72.
438 Ibid; See additional discussion at section 5.1.8.
Local government officials have an enormous amount of power. They are able to manipulate the decisions and approvals at the local level and have significant connections within the local communities. The local government is also responsible for the employment and resettlement of employees and social security benefits of SOEs if these were unable to be settled from the proceeds of a bankruptcy. They have a keen interest in keeping employees in work; otherwise, the costs will be borne by the local government. The local government wishes to keep its people in employment as it provides for social stability and gives the appearance that the officials are doing their jobs. Government officials, chair people and senior managers of companies and enterprises within the local area will most likely have personal ties. Since the business community will be relatively small and power is concentrated within a select small group of individuals in each region. It would be relatively easy for a businessperson to reach out to the local government for help as a result of guanxi.

Solution: Local government officials are connected to the local Courts and judges. Under the old bankruptcy law (similar to the “policy bankruptcies” of SOEs), a high degree of influence was imposed by the local government, as they were a party to the proceedings. Under the new law, this is not the case, however, such influence over the Courts may continue. Some evidence for this speculation appears in the Asia Aluminium case where the local government restricted foreign bidders and it was alleged that a deal was struck between the company’s management and local officials so that proceedings were to be pre-determined.\footnote{See Below at Section 4.2.5.} There are numerous other anecdotal accounts of local government officials becoming involved in the bankruptcy proceedings of companies, especially where foreign creditors and investors have been involved.\footnote{Personal conversation with Hong Kong-based bankruptcy lawyers (Hong Kong, 15 October 2009); Individual discussion with Hong Kong-based Restructuring Professional (26 October 2009).}
Judicial independence — allowing the Courts to function without the over-riding or perceived influence of the local government or any other outside sources — is required. This is a matter that China has been working on for quite some time. Peerenboom argues:

Comprehensive judicial reform is required. There must be improvements in judicial competence and efficiency, authority and independence. However, judicial reforms must be sequenced and implemented in accordance with the judiciary’s institutional capacity to change. Suddenly providing more authority and independence to incompetent and corrupt judges could result in more rather than fewer wrongly decided cases, which would then further undermine the legitimacy of the legal system.\(^{442}\)

Currently judicial independence is a multifaceted concept. Independence requires that the terms of judicial appointments be secure, appointments and promotions be depoliticized, judges provided with adequate salaries, transfers and promotions should be fair according prescribed rules and they should be assigned cases in an impartial manner.\(^{443}\) The development of the bankruptcy department (as described in section 6.1.1) might assist in this regard, as it would be the government department working with the Court creating additional means of internal independence.

5.1.3 Problem Three: The Legal Representative and the Company Chop

**Problem:** The system by which China uses a legal representative for executing legal contracts is a uniquely Chinese approach. In Western companies, the signature of the legal representative is the ultimate mark of authority; in China this is not so. A representative’s signature is rarely registered; therefore, the use of a chop (sometimes referred to in Western culture as a seal or stamp) is the ultimate mark of authority.\(^{444}\) The

\(^{443}\) Ibid, 298.
legal representative is the person who is appointed by the board of directors as stipulated in the articles of association lodged with the government administration authorities. In most cases, this responsibility lies within the role of the chairperson of the company; however, with recent changes to the Chinese company law, a general manager of a Wholly Foreign Owned Enterprise (WFOE) or a domestically owned enterprise is also eligible to hold the role of the legal representative.\textsuperscript{445} The system of a legal representative is similar to that of an agent in a common law jurisdiction. Every company in China is viewed as a legally independent person after it is established. Since a company is treated as a person, it must exercise its rights and duties through its agent.\textsuperscript{446}

\textbf{Analysis:} The problem associated with the legal representative and the chop is that when a bankruptcy case is filed, the administrator is charged with taking control of the company, accounts and chops as empowered by the EBL.\textsuperscript{447} In the majority of cases where creditors have filed the bankruptcy application, the legal representative would be opposed to this measure because if he or she is chairperson, it is his or her company. In these circumstances, gaining control over the chop could be physically difficult.

When a legal representative is replaced, the displaced legal representative must return the chop to the company so the new legal representative can represent the company. If the legal representative refuses to return the seal, the company could be liable for all the agreements the former legal representative has bound the company. Even if the Articles of Association can be used for the removal of the legal representative, it does not necessarily mean that a foreign investor or an administrator may be able to regain control.


\textsuperscript{447} Article 25, 2006 EBL.
of the company in practice.\footnote{Zhang Shouzhi, Xu Xizodan & Li Xiang Battle for the Company Seal (2009) King & Wood \<http://www.chinalawinsight.com/2009/09/articles/dispute-resolution/battle-for-the-company-seal/> \at 5 November 2009.} There is legislation on this point. The Company Law states that ‘directors, supervisors and senior managers shall not take advantage of their position to take bribes or other illegal income, and they shall not speculate with the company’s assets.’\footnote{Article 148(2) Company Law.} In addition, for a foreign investor, the Supreme People’s Court has made a judicial interpretation stating that ‘the people’s Courts will accept petitions from foreign invested companies attempting to retrieve a company seal from a natural person, legal person or other entity.’\footnote{SPC Interpretation of the Meeting Minutes of the Second National Forum of Foreign-Related Commercial Maritime Trials, 16 December 2006.} However, when a company files a petition in the Court to seek the return of the company chop, the petition must be stamped with the company chop. If the company chop is not available, then the Court will accept the legal representative’s signature on the petition, but the legal representative that signs the petition must be the legal representative listed on the company’s business license. This creates a problem, as the legal representative would clearly be unwilling to execute a proceeding against their self. There is a solution in that the company can install a new legal representative; however, there are several procedural issues that the Court and the company must overcome first.\footnote{Zhang Shouzhi, Xu Xizodan & Li Xiang, Battle for the Company Seal (2009) King & Wood \<http://www.chinalawinsight.com/2009/09/articles/dispute-resolution/battle-for-the-company-seal/> \at 5 November 2009.}

**Solution:** Replacing the legal representative can be done in a variety of different ways. There are a few options that may prove easier than others. One way would be for the legal representative to provide the foreign lenders an undated termination document as part of the documentation of the loan agreements that could be filed with local authorities replacing them as the legal representative and which would allow the foreign investors to
take control of the company and, for example, begin a Chapter 8 reorganisation procedure.\textsuperscript{452}

Where a Chinese company is held by an offshore holding company, as a pre-IPO structure may entail, it is possible to replace the directors of the company and the legal representative by having the offshore directors replaced and administrators appointed. In some instances, where there are close relations with foreign administrators and local officials, the regulators have replaced the directors of the Chinese company and legal representative following that of the company’s parent company and a resolution of its directors. This has only happened on a few occasions in practice where there are good relationships between the foreign administrators and the local government officials; however, it is an alternative solution to deal with the issue of the replacement of a representative.\textsuperscript{453}

Practising lawyers have suggested that the entire tradition of legal representatives and chops should be replaced with that of a board of directors and corporate resolutions.\textsuperscript{454}

The chop mechanism is antiquated and not of an international standard. Changing the system would enhance good corporate governance by placing the legal responsibility with a board of directors and not with a single individual. This is a matter for the regulators in China to review in the future.


\textsuperscript{453} Personal conversation with Hong Kong-based bankruptcy lawyers (Hong Kong, 15 October 2009).

\textsuperscript{454} Conversation with Hong Kong-based Restructuring Professional (26 October 2009).
5.1.4 Problem Four: Pre-IPO Placements

**Observations:** A pre-IPO placement is when a portion of an initial public offering (IPO) is placed with private investors before the IPO is scheduled to hit the market. Typically, these private investors are large private equity firms or hedge funds that are willing to buy a large stake in the company. The size of these investments means the price paid for shares results in a lower per share cost for the investor than the prospective IPO price.\(^{455}\)

Over the past few years, there has been a trend towards this type of financing to Chinese businesses through the offshore holding companies of those Chinese companies. A variety of different market factors contributed to the popularity of these investments, including:\(^{456}\) 1) low financing costs of borrowing US dollars offshore in comparison to borrowing them onshore, and the appreciation of the RBM; 2) attractive returns to the lenders in the event of a successful IPO; 3) ample liquidity in the PRC debt and equity markets reducing the risk of an IPO failing to list by a specified date; and 4) demand by companies in the PRC seeking funds to finance plans for rapid expansion in the booming economy and property markets.


Figure 2: Flowchart of Typical Pre-IPO Financing Structure used by Foreign Investing in China

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Ibid.
Chinese law restricts foreign investors that wish to hold onshore immovable assets in China. These assets must be held within the legal framework of a Foreign Invested Enterprise (FIE) with either a JV or WFOE being the most common structures. This onshore and offshore divide is seen in almost all Chinese-based investment structures. The parent holding company and head office is located in an offshore jurisdiction such as Hong Kong, Bermuda or the British Virgin Islands (BVI), whilst the actual operating and immovable assets such as factories, manufacturing plants, machinery, and real estate developments are held in the onshore company.\footnote{Ibid.} Foreign investment is usually to be made to the holding company that immediately holds the onshore JV or WFOE. The proceeds of this investment is then used as an equity injection or shareholders loan to the Chinese company, this results in the offshore lenders in effect providing a ‘holdco financing’. The importance of Hong Kong and Singapore being used for the jurisdiction in which the holding company is located is that there is an arrangement for the avoidance of double taxation on income, which provides preferred tax treatment to companies domiciled there.\footnote{Ibid. The Second Protocol to the Arrangement between the Mainland of China and the Hong Kong Special Administrative Region for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, 11 June 2008; The Second Protocol to the Agreement between the Government of the Republic of Singapore and the Government of the People’s Republic of China for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion, 11 July 2007.}

This entire process is used to establish the creation of security for the offshore lenders over the group assets. There must be a combination of different types of security arrangements in order to protect the foreign investor’s interests. The following are the typical security instruments that are available:\footnote{Baldwin Cheng & Karen Tang, Client Alert Financial Markets Developments, PRC Pre-IPO Financings: What are the Exit Options? (2009) White & Case <http://www.whitecase.com/alert_032009_4/> at 26 October 2009.} 1) parent and sponsor guarantees; 2) security of the equity interests in the onshore entity; 3) security over any offshore assets of the group; 4) negative covenants contained in the offshore credit agreement to limit
the amount of onshore debt and onshore security; 5) letter(s) of undertaking executed by
the onshore companies replicating the positive and negative covenants contained in the
offshore credit agreement; 6) covenants relating to increased control over conduct of the
relevant pre-IPO company; and 7) onshore security whereas the offshore lender also has
offshore operations (such as a PRC incorporated bank) where the onshore bank will make
a nominal loan in RMB to the company and take a general security agreement in favour
of the offshore lender, typically at many time the actual asset value. This ensures that the
lender acts as a placeholder for the interests of the offshore security over other onshore
lenders.

Pre-IPO financing in this structure in the lead-up to the Global Financial Crisis was very
popular. In 2006, there was US$890 million invested in such deals; US$520 million of
which went to China. This increased to US$3,557 million in 2007 with US$1,437 million
to China. Deal volume fell in 2008 to US$2,868 million with US$1,315 million to
China. The Chinese government implemented a series of changes in 2008 to limit the
appreciation of property prices. Then, restrictions on bank loans to property developers
and taxes on capital gains from secondary property sales caused a drastic effect on
property developers. These changes and the effects of the GFC has resulted in a
downturn in property development and many of these pre-IPO companies are now
suffering from financial stress, struggling to meet the financial covenants and servicing
their debt. It was estimated that two-thirds of the pre-IPO deals that are currently sitting
in limbo have the prospect of going into bankruptcy. Higher interest rates on this debt
financing are a common characteristic of this type of financing. They are structured on
the basis that the pre-IPO company will list by a certain date. Failure to do so will result

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462 Ibid.
463 Personal conversation with Hong Kong-based bankruptcy lawyers (Hong Kong, 16 October 2009).
in an increase in the interest rate. This is designed to limit the downside risk to the offshore lender if the IPO does not proceed. Other data from Thompson Reuters shows that in the first part of 2008, 21 IPOs were either cancelled or postponed in Hong Kong.\footnote{Chito Santiago, ‘Pre-IPO Deals Stuck as IPO Market Stalls’ The Asset Magazine (Hong Kong) May 2008, 36.} If a Pre-IPO company does not exit through an IPO by the required target date that the regulators set, there is a need to refinance or restructure the Pre-IPO deals because there is no way that the original Pre-IPO structure could sustain itself.\footnote{Ibid, 37.} A Hong Kong lawyer stated that ‘there will be a lot of refinancing and restructuring activities in this sector if the Hong Kong market does not turn around’.\footnote{Ibid.}

Trying to restructure this debt is difficult as there are limited ways to extract funds out of the mainland. The generally accepted protocol is by way of payment of dividends or repayments on shareholders loans. The investment into the mainland is normally injected either by a capital contribution or by a shareholders loan. Restructurings are further complicated when the pre-IPO financings have been often sold and distributed to other investors in either a participation or a Credit Default Swap (CDS) style instrument. This results in the lenders-on-record often not being the party bearing the risk of the credit.\footnote{Baldwin Cheng & Karen Tang, Client Alert Financial Markets Developments, PRC Pre-IPO Financings: What are the Exit Options? (2009) White & Case <http://www.whitecase.com/alert_032009_4/> at 26 October 2009.}

One of the most troubling aspects of this type of investment is that the Payment in Kind (PIK) notes that are issued to foreign investors has no priority in the event of a bankruptcy. A striking example is provided by the recent case of Asia Aluminium, where the PIK note holders received approximately one per cent return on their investment. Asia Aluminium is further discussed in section 4.2.5.
**Solutions:** Various options are available for lenders to exercise security over a pre-IPO company. These options will be dependent on various external factors, including the business model and asset value of the debtor, the influence of the sponsor in the province where the onshore subsidiaries operate, the amount of onshore debt and the familiarity of the onshore lenders with pre-IPO financings.\(^{468}\) It is important to note that the following enforcement mechanisms listed below are novel and untested:

1) **Taking legal action in Hong Kong.** Generally, this would involve seeking a judgment in the Hong Kong Courts over the Hong Kong holding company, the offshore debtor and its onshore subsidiaries based on the relevant financing documentation showing that the debtor has breached either its negative or positive covenants on the loan agreements. This will be dependent on whether there was a valid contract in place, establishment of breach of contact, proof that the breach caused alleged damages and to what extent the Hong Kong judgments may be enforced in China. It is important to note that a reciprocal recognition and enforcement of judgments agreement has been made between Hong Kong and the Mainland in which Article 1 states that where any Court in either Hong Kong or the Mainland has made an enforceable judgment requiring payment of money in a civil and commercial case, the parties may apply under the agreement for recognition and enforcement of the judgment.\(^{469}\) This applies to the mutual enforcement of civil and commercial judgments, but this does not extend to bankruptcy matters as the legislations will only apply where there is an express choice of jurisdiction clause.\(^{470}\) While this Agreement may provide a mechanism to enforce judgments, its application is limited, and there are some practical difficulties to the effective implementation of the Agreement. Both sides are currently using their best efforts to instigate appropriate

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\(^{468}\) Ibid.
\(^{469}\) Article 1, Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region pursuant to Choice of Court Agreements between Parties Concerned, Hong Kong Special Administrative Region.
legislation and promulgate relevant judicial interpretations to give the Agreement full effect.\textsuperscript{471} In the event of a bankruptcy proceeding on the Mainland, the Hong Kong Courts may not permit any attachment over the assets of such entity and there may be a prohibition that would prevent the commencement or continuation of any proceeding against the relevant Mainland entity, as discussed in the \textit{Guangdong International Trust \& Investment Corporation} case, which is discussed further in section 4.2.2.\textsuperscript{472} Hong Kong has recently revisited the notion of introducing a Corporate Rescue Bill, much like the US Chapter 11 bankruptcy proceedings. Previous drafts have failed due to issues of employee entitlements.\textsuperscript{473} If this Bill is successful, it will allow companies to enter a reorganisation process in Hong Kong instead of liquidation, giving more options and remedies to the investors.

2) Offshore enforcement. Appointment of an insolvency administrator by the offshore investors over the offshore borrower according to the laws governing the insolvency regime where the offshore borrower is domiciled, generally, Hong Kong or the British Virgin Islands (BVI).

3) Onshore enforcement. Enforcement of the Chinese equity pledges to enable the offshore investors to become a direct holder of the equity interest of the Chinese company.

The purpose of both 2 and 3 above is to gain control of the offshore borrower’s equity interest in the onshore entity and to appoint a new management, including legal


\textsuperscript{472} CCIC Finance Ltd. \textit{v} Guangdong International Trust \& Investment Corporation [2001] HKCEA 774.

\textsuperscript{473} Enoch Yiu, ‘Chapter 11 bill set for new try’, South China Morning Post (Hong Kong) 29 October 2009.
representative, over the onshore subsidiaries. In the event that the Chinese subsidiaries have been placed into a bankruptcy proceeding under the EBL, the ability to change management would be very difficult as the new Chinese administrator now controls the company. In the event that the offshore lenders are able to replace management, they may consider using the reorganisation process under Chapter 8 of the EBL and promote an offshore friendly reorganisation of the company; however, this researcher has not been able to find any instances in which this has occurred in China under the new EBL.

Companies that have been restructured or wound up include FerroChina Limited and GLC Silicon Technology Holdings. It is important to note that while this type of structured financing is still probably the best means of making investments within China, it does have inherent risks. China’s complex foreign investment laws have resulted in these special purpose offshore vehicles being created.

5.1.5 Problem Five: The Global Financial Crisis — Additional Non-performing Loans

Problem: The Global Financial Crisis (GFC) has taken a toll on the Chinese economy. There has been a drop in economic growth, as in the first half of 2009, China’s GDP grew by 7.1 per cent, down from 9.6 per cent the year before. Similar to most developed nations, China implemented an economic stimulus plan aimed at driving

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growth by consumption and investment by the provision of RMB four trillion over a two-
year period.\textsuperscript{476} In 2008 there were 2955 bankruptcy cases accepted under the EBL.\textsuperscript{477}

\textbf{Analysis:} China had a massive problem in the 1990s with Non-Performing Loans
(NPLs), and set up four Asset Management Companies (AMCs) to address this issue, as
discussed in Chapter 2. These AMCs would package the bad debts and sell off the
investments to foreign or domestic companies and/or investors. The 1986 Bankruptcy
law was used for some of these companies. NPLs and policy bankruptcies of SOEs were
commonplace throughout the 1990s.

The official numbers from the China Banking Regulatory Commission (CBRC) show
that there has been a decline in NPLs during 2009. The NPL ratio of lenders, including
foreign banks in China, was 2.04 per cent at the end of March 2009, down 0.38 per cent
from the beginning of 2009.\textsuperscript{478} In June 2009, this ratio again dropped to 1.8 per cent.\textsuperscript{479}
This is a substantial decrease, as it was 2.45 per cent at the end of 2008 and 3.71 per cent
in 2007.\textsuperscript{480} Total outstanding reported bad loans stood at RMB 549.5 billion at the end of
March 2009.\textsuperscript{481}

On the surface, it seems the CBRC appears to be controlling the situation; there will not
be a repeat of the previous NPL problem. However, there are certain policy decisions

\textsuperscript{476} Ibid.
\textsuperscript{477} Statistical Chart of Enterprise Bankruptcy Cases in China from 1998 to 2008 (2009) Siyuan Think Tank
\textsuperscript{478} China lenders continue to see falling non-performing loans (2009) China View
\textless http://www.xinhuanet.com/english/2009-04/14/content_11186420.htm\textgreater at 28 October 2009.
\textsuperscript{479} Wei Jiabao, Premier of the State Council of the People’s Republic of China, ‘Build up in All-round
Way the Internal Dynamism of China’s Economic Development’ (Speech delivered at the World
\textsuperscript{480} China lenders continue to see falling non-performing loans (2009) China View
\textless http://www.xinhuanet.com/english/2009-04/14/content_11186420.htm\textgreater at 28 October 2009.
\textsuperscript{481} Ibid.
that have affected the NPL ratio. In late 2007, People’s Courts across China invoked a self-imposed ‘three suspension policy’ including: 1) the suspension of filing of new NPL related cases; 2) obtaining judgments on existing cases; and 3) execution of decisions pending Supreme People’s Court guidance.482 This was a blow to investors hoping to use the Courts to effect payment and collection on their existing loans. This was further complicated in March 2009, when the Supreme Court issued guidance instructing Courts not to accept cases against state-owned or state-controlled enterprises if the debtor is in the midst of a reorganisation, or against state-owned banks if an investor discovers an undisclosed technical fault with the loan that hinders collection of the NPL after it had been sold to a purchaser.483

In July 2009 the Supreme People’s Court ruled against UBS in a case involving an SOE guarantor. Earlier in March 2009, in a guidance note from the Supreme Court it was stated that when NPLs are transferred by the AMCs to investors, the underlying guarantee remains valid and the guarantor is not required to give its consent for the transfer of the loan. This meant that a valuable piece of land pledged as collateral by a guarantor would remain a prime source of recovery for investors, even if the guarantor did not like the fact that someone else now owned the underlying loan. However, the Court in the UBS decision also cited a 2004 law that said the guarantor must provide consent for the transfer, and further, that the details of the guarantee must be registered with the local State Administration of Foreign Exchange Bureau.484 This decision is clearly in conflict with the guidance note and has significant implications for investors. If this is followed in the lower Courts, many guarantees will cease to exist and investor demand will decrease. As one investor recently stated in a newspaper article ‘every time

483 Ibid.
484 Ibid.
we think we understand the rules the authorities throw a new roadblock in our path”.\textsuperscript{485} There has been a substantial decrease in the amount of NPLs being purchased by foreign investors. There will be little demand for them until the guarantee issue becomes clearer. This may result in an increased number of bankruptcies of Chinese companies as there is no demand in the secondary markets for the sale of NPLs and the only remedy banks would have to collect these debts would be to either liquidate or reorganise the company under the EBL.

Chinese banks have been making loans in support of the Central Government’s policies to encourage the economy and stimulate consumption. There has been a record RMB 7.4 trillion in new loans made in the first six months of 2009. This equates to roughly one-quarter of the country’s GDP.\textsuperscript{486} One of the concerns is that much of this credit has been given out with relatively low lending criteria, below the normal standards of lending. This action may increase the percentage of NPLs by one to two percentage points. Lending in July and August 2009 slowed considerably after regulators began to worry about NPLs and assets bubbles, resulting in banks reining in credit growth.

**Solution:** New rules have been drafted to tighten the bank’s capital requirements.\textsuperscript{487} However, if current lending policies and the Court’s interpretations of guarantees on NPLs continue, the amount of bankruptcy cases filed in China over the next few years may increase. This is definitely an area of concern for the government and regulators.

\begin{flushright}
\textsuperscript{485} Ibid.  \\
\textsuperscript{487} Ibid.
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Drafts of new banking regulations are being created in order to deal with these issues and address these problems.\(^{488}\)

5.1.6 Problem Six: Proof of Debt Amounts in Chinese Contracts

**Problem:** There is growing concern within the restructuring profession in Hong Kong regarding the standards Chinese-based administrators are using in determining the allocation their clients will receive in the same class of creditors as onshore Chinese-based creditors. The appointment of sole administrators or members of their staff that do not have an accounting and legal background is a grave concern. There is anecdotal evidence of problems in determining the correct amount of the proof of debt and discrepancies that are not in favour of foreign creditors.\(^{489}\)

**Suggestions:** One concern is conflict in the understanding of the terms of contract and the disregard of private international law. Chinese administrators have been known to revert to Chinese law on international contracts and render a proof of debt on a contract that is not consistent with international standards.\(^{490}\) This undermines the intention of the parties and produces increased risk for business contracting with Chinese companies. These issues are a result of the general language used in the articles of the civil law legislation. Here, the Supreme People’s Court will look to any Western bankruptcy regime and implement similar regulations as to how to define and deal with proof of debt to international standards and correct determination of the creditor allocation. It seems that administrators are currently interpreting the legislation in a variety of ways and there is no congruent standard in this matter.

\(^{488}\) Personal conversation with Professor Wang Weigou, Dean of the School of Civil, Commercial and Economic Law, China University of Politics and Law (Beijing, 8 October 2009).

\(^{489}\) Individual discussion with Hong Kong-based Restructuring Professional (26 October 2009).

\(^{490}\) Ibid.
An example of this problem is an ongoing dispute between a recent high profile Chinese bankruptcy and a foreign supplier. A Chinese company entered into an agreement for the purchase of goods from a foreign supplier. The supplier is one of five major suppliers of the goods in the world. The standard process in which the goods are purchased is that an order is placed and there is an agreement in which a deposit is made and additional payments are made as work on the goods progresses. The final amount is due when the goods are accepted by the purchaser. The Chinese company then encountered a liquidity problem and a bankruptcy case was filed in the local People’s Court. The company was liquidated, as creditors and the Court could not accept a restructuring plan. According to the contract, if the purchaser defaulted on the payments or committed an act of insolvency, the supplier was entitled to keep the deposits and sell the product to another client. This is within acceptance of the generally accepted principals of international private law. The Chinese-based administrator took the view that the deposits were now void, and should be returned to the administrator for distribution to other onshore creditors. Apparently, this is consistent with Chinese law, but is in disagreement with international private law. The parties are now currently in arbitration trying to resolve this dispute. One of the concerns for foreign suppliers is that the Chinese approach is against the principles of contract and leads to extra risk for foreign companies doing business in China. Another interesting possibility regarding this issue is since the product comes from only one of five companies that produce it, there is the probability that there will be a restructuring of these contracts to deal with Chinese companies resulting in a higher price paid for the increased risk associated with the sale to Chinese companies.

491 Personal discussion with Hong Kong-based bankruptcy lawyers (Hong Kong, 16 October 2009).
5.1.7 Problem Seven: Alternatives to Bankruptcy

Problem: The GFC has been a real test for Chinese manufacturing companies, especially if they rely on exports to Western countries. Various Western-based news media reports have estimated that more than 100,000 companies have shut down due to the economic climate in 2009 alone.\(^492\) The informal exiting from the marketplace has the probability for leaving a widespread problem of creditors and employees not having claims dealt with in an appropriate way. However, there is no corresponding data showing that there has been a sharp increase in the number of bankruptcy applications in China. The true numbers of Chinese companies that are in such circumstances are very difficult to ascertain and over the next few years, the true numbers of insolvencies resulting from the GFC will become known.

Solution: There is a tendency to seek an alternative to bankruptcy as a remedy to the company’s financial situation, as this is a face-saving measure for the company president to avoid the shame of going bankrupt. There are different ways of dealing with a financially struggling company such as selling the business, selling equity to investors, seeking additional capital from non-traditional sources such as friends and family, seeking a foreign JV for injection of capital in exchange for a Chinese factory, or shutting the business temporarily with the hopes of reopening when the economic climate improves.\(^493\)

Another approach is that of negotiation and informal conciliation outside the legislation that the EBL provides. Banks and creditors often seek to make arrangements outside of


\(^{493}\) Individual discussion with Dr. Li Shuguang, Director of the Bankruptcy Law & Restructuring Centre – China University of Politics and Law (Beijing, 28 September 2009).
bankruptcy, because there is a level of certainty to such proceedings. In a formal application banks lose the power to control the direction of the proceedings.

The conciliation process that is afforded in bankruptcy or companies on the verge of bankruptcy is another viable option for consideration. This process is little used, as it is not fully understood by the Courts, administrators, lawyers and company directors. This process is a viable alternative to bankruptcy, and may provide a structured agreement under the protection of the Court.

494 Personal discussion with Hong Kong-based bankruptcy lawyers (Hong Kong, 16 October 2009).
6. BANKRUPTCY LAW AND REGULATION IN CHINA:
PROBLEMS AND SOLUTIONS

6.1 Issues and Problems with the 2006 Enterprise Bankruptcy Law

China’s transition to a socialist market based economy has presented numerous issues for regulators and law makers. Unprecedented growth has created unique problems making law reforms a ‘moving target’. The Chinese government and the Supreme People’s Court recently organised a special committee to produce judicial interpretations in order to flesh out technical shortcomings of the new law and resolve problems that had emerged in practice. As we shall see, however, issues resolved by means of judicial interpretations have merely scratched the surface and much larger underlying issues still exist. The following problems and solutions are related directly to law and regulation. It is expected that these issues will be at the forefront of bankruptcy practice in China for the next decade. Chapter 5 considered endogenous or systemic problems relating to the PRC legal regime. This chapter considers problems specific to the 2006 EBL and regulation.

6.1.1 Problem One: Lack of a Bankruptcy Infrastructure within China

Problem: China lacks the insolvency infrastructure required for the smooth operation of an insolvency regime. Many foreign states have government departments that act as the gatekeepers to bankruptcy, and which perform the functions of administration, policy review, case management and public trustee. Obvious examples are the USA and the UK. These systems have been fine-tuned over the decades in order to produce an effective

department that is able to deal with complex issues in bankruptcy and provide independent policy advice to the government for changes required in the legal framework.

**Solution:** The creation of a ‘Bankruptcy Department’ would supply the required infrastructure. Ideally, this bureau should be an independent department with autonomy in the decision making process and free of influence from other governmental departments. The biggest threat would come from the Supreme People’s Court, as they would naturally want to have control of this process; however, it can be argued that such control would give rise to conflict of interest as they would be creating laws to deal with the issues as they see fit.\(^{496}\)

This department would have five different responsibilities.\(^{497}\) These are: 1) policy development of new regulations and law; 2) making amendments to the current regulations and law; 3) issuing bankruptcy insurance policies to directors of companies; 4) acting as a public administrator; and 5) creating and managing an administrator association. These five functions are as follows:

1. **Policy development of new regulations and law.** The bankruptcy department would be the centralised government department in charge of directing policy development and the drafting and introduction of new regulations and law in China. It would function independently from the Supreme People’s Court. This independence and the centralisation of power is important since the bodies that create the law should not also enforce the law. Reporting directly to the National People’s Congress (NPC), it would have the ability to introduce regulations for practice and how proceedings are to be

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\(^{496}\) One-on-one discussion with Dr. Li Shuguang, Director of the Bankruptcy Law & Restructuring Centre – China University of Politics and Law (Beijing, 9 October 2009).

\(^{497}\) Ibid.
handled for consideration by the NPC. One concern here is that the EBL is not being used as the drafters due to many external factors, such as local governments, intended it and the continued use of “policy-bankruptcies.” The ability to achieve these original intentions and help create the framework for an optional insolvency regime is vital.

2. **Make amendments to the current regulations and law.** As with any legal system, history shows that a newly implemented law is never perfect and amendments must be made from time to time to deal with the changing times. The insolvency department would be charged with the responsibility of monitoring the performance of the bankruptcy law. This will allow an up-to-date analysis of the current situation complied with the ability to make modifications as necessary, before larger problems are manifested from smaller issues. Having a mandate to make the process efficient and suggest recommendations for modifications of either regulations or legislation would result in a much smoother process and greater acceptance of reorganisation and liquidations of companies where necessary.

3. **Bankruptcy insurance for company directors.** When a business becomes bankrupt, the creditors of that company become the real financial stakeholders in the business, bearing the risk of any loss suffered as the debtor continues to trade. The conduct and behaviour of the directors and management of the company has a direct effect on the recovery of assets to the creditors. If there is additional loss due to fraud, negligence or irresponsible behaviour by the director of management, an insolvency law must provide the possibility of recovery for damage or loss incurred by the creditors.\(^{498}\) The current framework provides that the directors and managers of a company are subject to

unlimited personal liability for these actions. Chinese law will allow a creditor to seek a judgment against an individual in these types of cases. However, certain instances may occur where the creditors are unable to seek compensation, such as if a director flees the country and disappears as has occurred in several recent smaller non-reported bankruptcy cases. Having an insurance system for directors and managers of companies provided by the bankruptcy department would solve many of these problems. Directors and managers would be able to execute their duties without the threat of personal prosecution, if they abide by the law and do not commit any acts of dishonesty. In the event something does happen that opens the possibility of a claim of director’s liability, and the directors can be proven not to have acted in a dishonest way, the insurance fund would be able to settle the claim with the creditors and the directors would escape any personal liability. This could occur where, for example, directors have honestly made attempts to complete a reorganisation or liquidation, or due to external factors such as Local Government officials extending influence over the proceedings, incorrect judicial practice of the Courts, or other factors have inhibited the director from acting in a manner that is consistent with good corporate governance.

4. Public administrator. The bankruptcy department would also have the role of a public administrator. The purpose of the role is for the winding up of bankrupt companies that have no assets. This situation can occur when a company has almost no assets and there is not enough money in the pool of assets to pay the administration costs of an administrator and run the proceedings in the Court. Here, the public administrator would step in and dissolve the company through the bankruptcy process. They would not be paid for this service from the pool of assets. They would perform the task as a public service provided through the framework of the department. Having a public administrator would also help when companies have been disbanded due to economic
problems, such as in recent examples of companies closing due to the Global Financial Crisis, directors taking all funds left in the accounts and fleeing overseas. In these instances, some assets may remain, such as land use rights and machinery; however, it would be difficult for an administrator to take on the file. A public administrator could use their expertise and run the proceedings smoothly to recover any assets and close out the company.

5. Administration association. With the new bankruptcy law comes the creation of a new profession, that of the administrator. Currently, the majority of administrators in China come mainly from one of two professions — accountants and lawyers, with a small number of local government officials. Creating one association that would handle the concerns of administrators and act as the main forum for raising concerns with the government would provide a strong forum for discussion. The association would have a variety of roles including:

A. Regulation and licensing of administrators. The association would be responsible for self-governance much like an accounting or law association. To become a member, an individual must have the necessary education, practical experience and other criteria that the association feels appropriate. The association would license administrators to practice as an administrator and the individual would be required to keep up-to-date on changes in regulations, law and practice. It would function much as its accounting and legal counterparts, and members would most likely hold licenses in both professions.

B. Code of practice. Similar to many professional organisations, a code of practice ensures that the administrator will fulfil his or her duties in accordance with the
code. This would be a high-level code that would enhance professionalism and diligence administrator.

C. Education. The association would act as the first point of contact for the education of administrators. Courses and seminars would be offered to the members with a minimum criterion of continuing education each year. This would be an effective way to educate administrators in how to properly administer a bankrupt estate and keep up-to-date with the newest changes in policy and regulations. Having a national association would also standardise the qualifications of administrators in every part of China.

D. Insurance. According to current rules for the selection of administrators, the administrator must hold insurance for negligence as a requirement of being an administrator. Many of current administrators hold these policies under their professional insurance. However, with the creation of a new profession, there could be specific administrator insurance that would cover the administrators for any claims of negligence. This could be done in one of two ways. Firstly, there could be a common fund run by the association as a form of self-insurance. Secondly, private insurance companies could develop a specific insurance policy to offer administrators.

E. Self-regulation. The administration association would be able to self-govern its members. In the event that an administrator fails to adhere to the rules that govern administrations, the association could hold a discipline hearing and an ad hoc tribunal would hear the case against an administrator and issue a decision regarding
punishment, be it in the form of fines or loss of membership and the ability to practice as an administrator.

6.1.2 Problem Two: Lack of Cross-Border Insolvency Mechanisms with China

**Problem:** There is a lack of cross-border insolvency cases involving China due to lack of detailed and practical mechanisms. There are a variety of reasons for this phenomenon, ranging from the uncertainties of legal proceedings in China to the foreign recognition of Chinese judgments. One main reason is a result of the foreign investment structure required for inbound investment into China, such as the use of wholly foreign-owned enterprises and JV arrangements. These investment vehicles result in a Chinese-based company that is subject to the EBL. Foreign companies have decided to structure the closing of these businesses in a variety of different ways, such as selling the onshore assets, closing the venture and writing off the losses or mothballing a factory for future use. The perception of a lack of certainty within the Chinese bankruptcy regime has been a deterrent for international companies resulting in no desire for the issuance of proceedings.499

The UNCITRAL Model Law on cross-border insolvencies, as discussed in section 3.7.2, has not been adopted in China as the drafters of the Model Law intended. However, the introduction of Article 5 of the EBL provides for international recognition of bankruptcy cases and judgments. This raises the possibility of recognition of a cross-border case.

Article 7 of the EBL seeks to have worldwide effect as it is the only mention of extraterritoriality. This is a move away from a territoriality approach traditionally

499 Personal conversations with Hong Kong-based bankruptcy lawyers (Hong Kong, 15 October 2009).
adopted in previous Chinese bankruptcy cases. There is still a need for bilateral treaties or reciprocal arrangements between nations to truly have proper effect of the law.\textsuperscript{500}

The United States has had a few cases under the new Chapter 15 of the US Bankruptcy Code. This chapter is the mechanism by which the US implemented the UNITRAL Model Law on cross-border insolvencies. The US case law gives some guidance as to how a US Court would accept a Chinese bankruptcy. The bankruptcy case of De Coro Limited, a Hong Kong registered company with extensive manufacturing operations in China, was the first case to apply successfully to a US Court for the recognition of a foreign (Hong Kong) proceeding.\textsuperscript{501} To date, this is the only case of its kind on record in the US. However, this does fall within the common practice of foreign investment into China using proper foreign business structures for inbound investment, such as Hong Kong holding companies and JVs. The researcher was unable to ascertain any information as to what is happening to wholly owned subsidiaries of De Coro Limited in China and if the Chinese Courts have accepted the Hong Kong proceedings.

Obtaining information about Chinese cases is difficult. The Courts tend to keep matters private, unlike the openness of registries in common law jurisdictions. It is difficult to obtain information as there is no central registry and Chinese judgments are typically very short in length and do not offer an explanation for why the decision was made. Transparency in these proceedings is needed. The reasoning of the Courts needs to be more widely understood. This would provide additional comfort to overseas creditors.


\textsuperscript{501} Re: De Coro Limited 09-10369 NC (Middle District, Greensboro Division).
who could see what had occurred in the past and use such experiences as a guide for current or future proceedings.

**Solution:** It would be useful to have a few test cases regarding cross-border insolvencies. These test cases should include Chinese insolvency cases accepted in a major common law jurisdiction such as the US, Australia or the UK, and cases in which one of these countries has a proceeding from their country accepted by the Chinese Courts, with successful recovery of assets.

### 6.1.3 Problem Three: Need for Additional Creditors’ Rights

**Problem:** There have been various pieces of anecdotal evidence indicating that creditors should have additional rights in a bankruptcy case. In a liquidation or reorganisation, the banks have a great deal to lose and their concerns are not being addressed fully. In one conversation with a respected academic it was expressed that this was one of their chief concerns.\(^{502}\)

**Solution:**

1. **Not enough creditor influence.** Creditors should place more weight on the creditors’ meeting and the resolution of reorganisation plans. The current legislation provides a mechanism by which creditors can apply to the Court for the replacement of administrators if they are in disagreement with the plan. However, in practice this is not always the case. As discussed above in 5.1.2, the local government officials have too

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\(^{502}\) Personal discussion with Professor Wang Weigou, Dean of the School of Civil, Commercial and Economic Law, China University of Politics and Law (Beijing, 8 October 2009); Personal conversation with Hong Kong-based bankruptcy lawyers (Hong Kong, 16 October 2009).
much power over the direction of a liquidation or reorganisation. This was shown in the *Asia Aluminium case* in section 4.2.5.

2. **More creditor participation in bankruptcy proceedings.** In various Western insolvency regimes, the creditors play an important role in the reorganisation process of companies. China has yet to fully develop a culture of business reorganisation. As a culture of reorganisation begins to develop in future, there should be more participation of creditors in the bankruptcy proceeding;

3. **Foreign creditors.** Foreign creditors of companies that do not hold onshore security in the debtor are generally unable to participate in the bankruptcy proceeding. On the other hand, foreign investors may desire to invest in distressed companies. The current framework makes it difficult to execute such an investment because of structure of inbound investment into China.

4. **Best interest of the creditors.** Creditors of the company have the most to lose. Their interests are not being addressed as the drafters of the law anticipated. The best result for creditors is the successful reorganisation of an enterprise or a liquidation that receives the highest return to all classes of creditors possible. Giving the creditors of the enterprise the option to make additional investment or participate in the conciliation process as an alternative to bankruptcy would be a good outcome that would benefit creditors.

5. **Equitable treatment among creditors.** There has been inconsistent treatment among creditors within the same class. Priorities are sometimes given to local creditors over others from a different municipality. In some instances, the banks have been given a
strong voice, but trade creditors have not even been notified of the bankruptcy proceedings in writing. Increased transparency is required to ensure that there is equitable treatment among the same class.

6.1.4 Problem Four: Finalisation of Policy Bankruptcies

**Problem:** ‘Policy bankruptcies’ of SOEs that are being rehabilitated using the EBL as a restructuring tool are still being finalised.\(^{503}\) Many Chinese companies have gone through this process since the first bankruptcy process was introduced in 1986. Some have used debt-equity swaps as in the Chongchung approach.\(^{504}\) The State-Owned Assets Supervision and Administration Commission (SASAC) remains the main body that regulates the policy bankruptcies and is still in the process of finalising the issue. SASAC issued regulations stating that June 2008 would be the final deadline for an estimated ‘final batch’ of 698 SOEs; however, this date has past and the goal was not met.\(^{505}\)

**Analysis:** As of October 2009, the policy bankruptcies are still not complete and the SASAC is currently working towards finalising this issue. It seems that whenever the SASAC is ‘almost’ done, there are always a few more hundred policy bankruptcies that need to be dealt with. It is estimated by some academics that it will take many more years until this process is finally complete.\(^{506}\) There is a tendency to add additional companies to the list and this is increasing the length of time needed to complete the task. Several local governments outside of the main commercial areas in China wish to continue with the set-off mechanisms of policy bankruptcies in dealing with bad debts, as this can


\(^{504}\) See footnote 214.

\(^{505}\) Zhang Xian Chu ‘Developments Since the Adoption of the New Enterprise Bankruptcy Law of the PRC’

address the issues of worker relocation in a simpler and more cost-effective manner than the local government can achieve.\textsuperscript{507} This phenomenon will probably continue until the practice is put to a stop. The Global Financial Crisis is thought to contribute to the problem. Issues related to corporate failures and shifts in global economics will no doubt allow the process to continue.\textsuperscript{508}

**Solution:** One of the underlying issues regarding policy bankruptcies is the ‘shield’ it gives to use the company’s assets to settle claims by workers. The balancing of workers’ rights, local government issues, local community, the debtor and its creditors is a highly contentious political issue. In times of global financial instability it would appear to be irresponsible for the government to let the pieces lie where they fall. Industrial action by workers has been evident in various bankruptcy cases throughout China recently. There have been demonstrations, walkouts and barricades of the entrances to factories. Comments have been made in academia and the legal profession as the ‘SASAC has not begun to use the new bankruptcy law, and they dare not do it’.\textsuperscript{509} If the SASAC was to use the new bankruptcy law, the company would first have to pay off secured creditors and employees would be ranked in order with others, since they would lose the super-priority that they enjoyed under the 1986 EBL. Therefore, the basic needs of workers are a high priority for the government, and it would be politically too expensive to settle these issues under the 2006 EBL. There are also some complex security arrangements between SOEs as there are guarantees between, for example, a manufacturing company and a financial institution. If the 2006 EBL were used for bankruptcy, the bank would be forced to act on its security and take the first priority position in a liquidation of the firm. If the workers’ claims are put ahead of secured creditors, this puts the corresponding

\textsuperscript{507} Personal conversation with Dr. Li Shuguang, Director of the Bankruptcy Law & Restructuring Centre – China University of Politics and Law (Beijing, 28 September 2009).

\textsuperscript{508} Ibid.

positions of disbursements, and goes against the fundamental purpose of removing the super priority of employee claims as found in the old 1986 Bankruptcy law. Current policy measures by the SASAC are aimed at avoiding this problem as it goes against the current growth strategy of the CCP.

An additional underlying problem is the social security system in China. Profitability and revenue is declining for SOEs as they face additional competition from private industry and other developing nations in the region. These SOEs are under pressure to be more efficient and self-funding. If there were a proper social security system to deal with these issues, this would eliminate the need for intervention by the government in these types of distressed companies.

The key issue regarding policy bankruptcies is the ongoing extensions and no final date to finalise them. The research undertaken for this thesis did not find any information demonstrating that a moratorium has been put in place restricting the addition of additional companies to the list. If a moratorium mechanism were to be used, the finalisation of policy bankruptcies could be dealt with in a timely manner over the next few years. Having the Courts and the marketplace sort out these issues would be ideal and provide the Chinese bankruptcy regime with the creditability it needs to harmonise the treatment of SOEs and all other enterprises in China by eliminating dual standards of treatment. When the finalisation of planned bankruptcies occurs, “it will symbolize a milestone in the gradual establishment of the market economy in China.”

6.1.5 Problem Five: Need for Training Special Bankruptcy Judges and Creation of Special Bankruptcy Courts

**Problem:** In various Western countries, special bankruptcy Courts and dedicated judges are assigned to oversee the proceedings. Specialised bankruptcy judges with specific training and experience oversee the proceedings and functioning of the Courts. Bankruptcy law extends through many different areas of law, and having dedicated judges and Courts allows for the efficient functioning of proceedings. The rationale for establishing a special Bankruptcy Court is that bankruptcy cases are fundamentally different from general civil cases and the results of bankruptcy cases may have effects on the economy as a whole. Further, it was considered necessary in western legal systems to have judges with specialised experience and training in bankruptcy cases presiding in these cases. For instance, in the US, each of the 94 federal judicial districts has its own bankruptcy Court. Thailand introduced a new bankruptcy Court in 1999 as part of a series of legislative bills designed to rectify problems in the legal infrastructure of Thailand that were highlighted by its economic crisis during the 1990s.

**Solutions:** In the past, ‘special’ bankruptcy Courts were convened for the specific purpose of policy bankruptcies of high profile SOEs under the 1986 EBL. Usually, an intermediate or higher-level People’s Court would hear the case. The introduction of a special bankruptcy Court designed for the specific purpose of bankruptcies only would be of great benefit to the bankruptcy infrastructure in China. This centralised environment would ensure that cases are dealt within a forum specific to the needs of bankruptcy. There is a precedent for this suggestion. There has been some introduction

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of bankruptcy courts, for example, in Shenzhen, which founded such a specialised Court in 1993. This court was instrumental in the formulation of some of the first professional instructions, such as the Operating Rules of Bankruptcy Courts, the Instructions on Time Limits in Bankruptcy Cases and the Operating Rules of Liquidation teams. It is important to note, however, that these rules were developed under the 1986 EBL and are no longer in effect under the 2006 EBL.

The number of bankruptcy cases in China each year is an extremely low percentage of total cases. In 2008, a total of 10.71 million cases were handled by the Courts,\textsuperscript{514} of which only 2,955 were bankruptcy cases.\textsuperscript{515} On these figures, bankruptcy cases accounting for 0.028 per cent of all cases. The average Chinese judge would rarely see a bankruptcy case and would not possess the special knowledge needed unless specific training had been provided. With the increasing number of other commercial matters, bankruptcy law will most likely be considered less important than the other pressing needs of the Courts. For these reasons, a special Court and specifically trained judges to deal with bankruptcy matters is the optimal solution.

The use of bankruptcy judges is a long tradition in Western legal cultures. These judges are specifically trained in the use of bankruptcy law, for both commercial and personal proceedings. It is important to understand that judges must possess this specific knowledge as an incorrect or uninformed decision in a bankruptcy case can have an immediate negative consequence on the debtor, creditors, employees, community, Local Government, national government and international parties. Unlike some civil cases between parties, the damage could be immediate and irreversible.

Bankruptcy cases under the old EBL have largely been policy bankruptcies. The judges have been following schedules arranged by the local government officials directing the proceedings and have not had to make independent decisions regarding cases.\textsuperscript{516} The ability for judges to handle such cases can vary greatly. In general in China, judges from large cities are relatively well educated and have accumulated considerable experience while their counterparts in small cities and underdeveloped regions do not have the genuine understanding of the practical and theoretical levels of bankruptcy law and commercial law.\textsuperscript{517}

There is a growing trend for Chinese judges to travel abroad to learn about both common and civil law in their respective jurisdictions, as well as the principles of private international law. Law schools from the US, Canada, Australia, Hong Kong and England have reported an increasing number of Chinese nationals partaking in Master of Laws degrees for international students and various intensive training programs.

Giving the court the power and the knowledge to modify and amend plans in the case of disagreements by the parties will help avoid deadlock. In instances where creditors’ meeting cannot approve the management or valuation plans for the bankrupt, the Court can make a decision on its own. These powers are vested in the Court if the creditors’ meeting cannot adopt the distribution plan after two meetings.\textsuperscript{518} The introduction of restructuring under Chapter 8 of the EBL can be complex and may seem foreign to many individuals involved in the process. Previously, they would only be familiar with the process of liquidation of a company. In order to have an increased acceptance of reorganisations, the courts and judges must be able to use their powers to execute the


\textsuperscript{517} Ibid.

\textsuperscript{518} Ibid, 679
procedure under the new law. China is still experimenting with restructuring judicial practice. Here, the most important task is to set up the structure that will create optimal conditions for restructuring proceedings.\(^{519}\)

**Solution:** The training of judges to act as bankruptcy judges a matter that China needs to review and implement. However, there are some more pressing issues that have been previously discussed and thus this training is not a priority. Chinese academics see merit in dedicated bankruptcy judges. They think it would be of value to the bankruptcy infrastructure and help in the development of a culture that accepts bankruptcy more readily.\(^{520}\) The ability to have important documents and motions in the proceeding, such as the declaration statement, draft reorganisation plan, conciliation agreement, and assets distribution plan should also be submitted to the Court for approval.

### 6.1.6 Problem Six: Non-Use of New Enterprise Bankruptcy Law

**Problem:** There is some anecdotal evidence that the law and the procedures implemented under the new bankruptcy law are not being followed in some outlying provinces in China. There is speculation that the framework of the old 1986 Bankruptcy Law is still being used in some cases, as the new law has not been disseminated throughout the legal profession and courts in rural China. Local Governments have a heavy influence on liquidation committees and the judiciary.\(^{521}\) It seems that old habits are hard to change in China.

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\(^{520}\) Personal conversation with Professor Wang Weigou, Dean of the School of Civil, Commercial and Economic Law, China University of Politics and Law (Beijing, 8 October 2009); Personal discussion with Dr. Li Shuguang, Director of the Bankruptcy Law & Restructuring Centre, China University of Politics and Law (Beijing, 28 September 2009).

\(^{521}\) Information provided by Hong Kong Lawyer, (e-mail, 3 August 2009).
This practice of the law not being followed has been exemplified in the UBS cases discussed in section 5.1.5 in which the Supreme People’s Court did not follow a recent direction regarding guarantees of NPLs, instead relying on an older inconsistent law. This has caused the investment community significant concerns regarding the judicial system and the application of law within China.

Solution: As discussed throughout this Chapter, there needs to be additional infrastructure and education of bankruptcy administrators, judges, lawyers and government officials in order to make sure that all parties are dealing with the current law and updated regulations.

6.1.7 Problem Seven: Need for Increased Corporate Governance

Problem: China has made massive strides towards a system of good corporate governance over the past decade. It has launched numerous initiatives to enhance corporate governance and trying to reach to an international standard such as the Organization of Economic and Development, Principles of Corporate Governance. The effects of globalisation have integrated China extremely quickly in to the global economy.

**Solutions:** The evolution of a corporate governance structure in China has been developed through the Company Law and the listing regulations. The listing rule for listed companies on various stock exchanges has produced a decent set of rules by which enterprises govern themselves. The true problem lies, similar to many Asian governance systems, in the fact that corporate governance laws are over-regulated and under-enforced.\(^{523}\) Rajagopalan and Zhang write that there are essentially four major shortcomings in the development of a good corporate governance system in China, which are as follows:

1. **Lack of incentives:** There are no compelling incentives for the key parties (for example, regulators, boards of directors/supervisors and management) to implement these changes. The government’s desire for short-term economic growth makes it less willing to force large corporations to protect minority shareholders. Regulatory bodies rarely are forced into action unless they are spurred by an emergency or high profile case. Investors, both domestic and foreign, are reluctant to become involved in implementing governance reforms, as they largely seek short-term gain rather than long-term investment. Management does not have strong incentives to implement reforms, unless it helps them accomplish immediate goals, such as gaining access to foreign investment.\(^{524}\)

2. **Power of the dominant shareholder:** If a Chinese enterprise is not an SOE, there is usually a dominate shareholder that is either a business group or family. In SOEs, the government owns the controlling interests of the enterprise. There is generally a conflict as minority shareholders interests are overrun by the interests of the dominant shareholder. Where dominant shareholders use pyramidal ownership structures, they can

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\(^{524}\) Ibid, 61.
achieve greater control of the enterprise through interlocking ownership, and can benefit from related party transactions. The minority shareholder may be harmed by this dominance and regulating this issue is particularly difficult due to the traditional agency problems between shareholders and management, and the dominant shareholder and minority shareholders.525

3. Underdeveloped external monitoring systems: The majority of initiatives that have been introduced for good corporate governance have been mainly internal mechanisms, emphasising the responsibilities of directors and management with the necessity for disclosure of information. External monitoring systems are required for the efficient operation of a corporate governance regime. China’s systems are still in their infancy, and this can prohibit the effective implementation of the reforms. Corruption is still a problem within China despite numerous government initiatives to prohibit the practice. A key approach to tackle the corruption problems is by prescribing greater transparency of transactions across business and government dealings.526

4. Independent directors: In 2001, China implemented a requirement that the board of directors of an enterprise must have independent directors. This was a landmark initiative; however, there numerous problems remain. Some individuals may appear to be an outside director, but may be former employees, outside counsel providing financial or legal advice, close family members or senior management, government officials, University professor, and nominees from financial institutions. These directors bring with them numerous conflicts and there is a lack of true independence. There is also a

525 Ibid.
526 Ibid, 62.
shortage of qualified candidates to carry out the role of a truly independent director. It has been suggested that foreign directors be appointed to Chinese companies.\textsuperscript{527}

Professor Wang writes that the new EBL will play a positive role in improving corporate governance in China:\textsuperscript{528}

First, when anticipating the legal effect of their conduct under the bankruptcy procedure, they shall have incentive to operate business with greater care, either fighting against financial difficulties or avoiding fraudulent transactions. Second, realising the risk of possible investigation and legal punishment provided in the new Law, they shall have less courage to take advantage of bankruptcy for weaselling from liabilities, so that the must meliorate their manner in carrying out their managerial functions.

Since the key issue of corporate governance is transparency or information disclosure, creditors are provided with a supervision power under the circumstances in corporate bankruptcy. Judicial authority and some professional associations support the power exercised. This should be a strong force to encourage a company’s management to work in higher loyalty and diligence, thus resulting in transparency and good corporate governance.\textsuperscript{529}

It is necessary to address these issues in the governance of a Chinese enterprise. Where there are failures in these governance issues, this may increase the problems that will be encountered in bankruptcy proceedings and there may be a reduction in the percentage of bankruptcy assets the investor would have received if there was a better structure in place.

\textsuperscript{527} Ibid, 64.
\textsuperscript{529} Ibid.
Problem Eight: Automatic Stay of Proceedings

Problem: There is the potential for harm to secured creditors as a result of the automatic stay of proceedings against the debtor. There are no specific requirements by the Court in providing a time line for making a decision in the type of proceeding that is to be undertaken, such as liquidation, conciliation or restructuring. It is possible that a significant period of time may pass before the case can be brought forward. In some instances where the secured property is time sensitive, such as with technology, the value of the property can depreciate extremely quickly and when the settlement finally occurs, the value of the property may be worthless, thus resulting in a much lower recovery. However, as stated in section 3.6, if the value of the property would be devalued or damaged in a reorganisation process, a creditor may seek relief from the automatic stay of proceedings. Individual creditors may also initiate litigation against the property of the debtor during this period. As a result, the moratorium legislation is not wholly effective and sufficient.\(^{530}\)

Solution: As discussed in section 3.6, these principles go against international best practice. In certain foreign states, a secured creditor can apply for leave from the Court upon showing just cause and not be subject to a stay of proceedings. This can be a deterrent for foreign creditors wishing to use the bankruptcy process in China for settlement of a debt. There is additional risk — there is no path for a secured creditor to seize the property and recoup their losses. This may be one of reasons why the use of the EBL is a last resort for foreign creditors doing business in China. It may not be in the creditor’s best interests to file a bankruptcy proceeding, as when they do so, they are unable to deal with their secured property, as they would have before the proceedings were filed. Executing the requisite security agreements before proceedings and

negotiation are much more advantageous to a foreign creditor or company as they are able to control the process. They lose whatever power they once had once the proceedings are accepted and this is not in the best interests of creditors. This is further complicated as China does not have a developed system to enforce security. If there was a mechanism to enforce security through the Courts, without having to seek leave of the court to make the enforcement, this would simplify the matter significantly.

6.1.9 Problem Nine: False Bankruptcy Cases

Problem: Numerous accounts have been reported regarding the problem of ‘false’ or ‘fake’ bankruptcy cases within China. These issues were raised by Professor Li Shuguang previously in section 2.3.5 where he discussed the problem of company directors and managers declaring bankruptcy after splitting off the profitable part of the business into another entity and changing licenses for their own personal benefit.531 This problem is still ongoing, as it was a problem in the Monkey King case (section 4.2.5) where the company prior to the financial downfall of the company sold the majority of the assets. Most recently questions have been raised in the Asia Aluminum Case (section 4.5.6) where the former chairman and chief executive are being accused of funnelling cash into a shell company which they had interests in three months before they announced that Asia Aluminum was in trouble.532 Other non-reported smaller cases have been commonly known throughout China where the director of a company would convert all available assets that are convertible to cash and leave the country or go into hiding with the companies money before the beginning of a bankruptcy proceeding.533

532 Naomi Rovnick ‘Asia Aluminium’s former top two sued over cash’ South China Morning Post Hong Kong, 17 March 2009.
533 Personal conversation with Dr. Li Shuguang, Director of the Bankruptcy Law & Restructuring Centre – China University of Politics and Law (Beijing, 28 September 2009).
Chinese regulators have recognised this problem and have now criminalised the practice of false bankruptcies under the Chinese Criminal Law.\footnote{Chinese Criminal Law, Amendment No VI (2006).} Creditors also have another remedy available under the Company Law where if a creditor has suffered a loss, they can sue the responsible shareholders or directors.\footnote{Article 19, Chinese Company Law: Second Regulation (2008).} This of course relays on the ability to locate the debtor. The problem of debtors fleeing China was also highlighted by the issuance by the SPC in the Guidelines for the Chinese Interested Partied Related to the Abnormal Pullout of Foreign Investment to Conduct Transnational Investigation and Litigation, where it was highlighted that there is a relative small number of remedies available for creditors in such situations.\footnote{Vivienne Bath and Mary Ip, ‘Wealth and loss in changing economic times – reforms in bankruptcy and consumer protection laws’ in John Garrick (ed) Law, Wealth and Power in China (2010).}

**Solution:** The problem of false bankruptcies and the transferring of monies by directors is a complex problem. Initial steps have been taken to make fake bankruptcies criminal. Increased amounts of corporate governance where transparency of the company is provided to creditors and risk managers would assist in the early detection of such acts. Additional clarification of treaties between foreign states in the recognition and enforcement of Chinese judgments against individuals found to be outside of China would also assist in the problem. Additional laws to give courts more power in attaching assets of the director to the bankruptcy case for disbursement to creditors. Overall, the stigma associated with bankruptcy and the directors not willing to loose face are major issues. The growth of a bankruptcy culture over time will assist with the understanding of the remedies available and hopefully reduce the number of these cases.
6.1.10 Problem Ten: Personal Bankruptcy Regime

**Problem:** The current framework of bankruptcy law in China deals exclusively with that of legal person enterprises, and does not address any issues of a personal bankruptcy. The original Bankruptcy Law in 1986 focused on SOEs as they were the only type of entity at the time to which it would apply under the scope of the law. The drafters of the 2006 EBL discussed in 1996 and 2000 whether or not to include a limited or full expansion to individuals under that law. In 1986, when the law was first introduced, China was in the initial stage of making the transition from a planned economy to a market-based economy and there were few opportunities for consumer finance. This trend follows the early US and UK traditions of the 1800s, where only merchants and others that were engaged in commerce were able to file for bankruptcy. Modern personal bankruptcy regimes developed over a hundred years later as the consumer developed and modern credit systems became more prevalent.

**Analysis:** The only current system of dealing with personal debts is found under two current sections of the Chinese Civil Law. Firstly, Article 107 of the General Principles of Civil law states ‘civil liability shall not be borne for failure to perform a contract or damage to a third party if it is caused by force majeure, except as otherwise provided by law’. The Civil Procedure Law provides the Court with additional remedies to satisfy debts and judgments. Article 221 provides the Court with the ability to freeze, transfer and deal with bank accounts of the debtor in order to fulfil the debt. Article 222 gives the Court the right to exercise a garnishee over the income of a person to fulfil the

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539 Article 107, 1986 General Principles of Civil Law.
540 Article 221, 1991 Civil Procedure Law.
debt.\textsuperscript{541} Article 223 gives the Courts the right to sell, freeze, and auction the debtor’s property either wholly or in part to settle the debts. Monies taken must not be in excess of the necessities of life nor can the court attach property of other dependant family members.\textsuperscript{542} In addition to these remedies, Article 233 gives the Courts the power to extend the execution orders for collection of debt to other assets as they become available. The debtor must continue to fulfil his or her obligations to pay the debt incurred.\textsuperscript{543} In addition to the above laws, other legislation provides the consumer with legal protection such as the Law of Protection of Consumer Rights and Interests,\textsuperscript{544} the Law of Advertising,\textsuperscript{545} the Law or Product Quality\textsuperscript{546} and the amended Law of Contract.\textsuperscript{547}

The Partnership Enterprise Law\textsuperscript{548} and the Law of Sole Proprietorship Enterprises\textsuperscript{549} provided for unlimited joint and several liabilities for partners or sole business owners of all debts of the business enterprise. Article 92 of the Partnership Enterprise Law provides that ‘where a partnership enterprise is unable to pay off its due debts, the creditors may apply to the people’s Court for bankruptcy liquidation, or may request the common partners to make repayments. Where a partnership is declared bankrupt, the common partners shall still bear joint and several liabilities for the debts of the partnership enterprise.’\textsuperscript{550} Considering the Individual Proprietorship Law, Article 28 provides that when a ‘proprietorship enterprise is dissolved; its original investor shall be liable to pay the debts of the enterprise incurred during the period of its continued existence’.\textsuperscript{551}

\textsuperscript{541} Article 222, 1991 Civil Procedure Law.
\textsuperscript{542} Article 223, 1991 Civil Procedure Law.
\textsuperscript{543} Article 233, 1991 Civil Procedure Law.
\textsuperscript{544} 1993 Law of Protection of Consumer Rights and Interests.
\textsuperscript{545} 1993 Law of Advertising.
\textsuperscript{546} 2000 Law of Product Quality.
\textsuperscript{547} 1999 Law of Contract.
\textsuperscript{548} 1997 Partnership Enterprise Law.
\textsuperscript{549} 1999 Law of Sole Proprietorship Enterprises.
\textsuperscript{550} Article 92 Partnership Enterprise Law (Amended 2006)
\textsuperscript{551} Article 28, 1999 Individual Proprietorship Enterprise Law.
Further, Article 31 provides that ‘where the property of an individual proprietorship enterprise is insufficient for liquidation, the investor shall pay off the debts with his own property’.

In Western countries that have a more developed system of partnership and sole proprietorships, there are some similarities to the Chinese system. In the event of an individual undertaking a business venture as a sole proprietor without the use of a separate legal entity; the individual is personally liable for the debts of the venture. The system of having small legal entities that have their own legal liability is non-existent in China.

In dealing with the public interest, a modern state provides a minimum level of living standard to its citizens. China has a long record of placing economic interests ahead of civil and political freedoms. This is known as the “liberty trade-off” that is commonly practiced in many Asian nations, including China. Though not expressly stated, there is also the concept of equity trade-off, whereby ‘economic growth will not benefit all equally, and may in the short term actually increase inequality and make some of the least well off even worse off’. Since the Central Government takes this approach to economic growth, it becomes apparent that the individual is placed at most risk for economic harm for the betterment of the state. There are certain trends in personal economic problems that must be addressed, as the future economic growth of the country will become more dependent on its people and their personal economic situations in the future.

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552 Article 31, 1999 Individual Proprietorship Enterprise Law.
554 Ibid.
On 12 May 2008, an 8.0 magnitude earthquake hit Wenchuan County, Sichuan Province in southwest China. This earthquake was the most destructive natural disaster to occur in China for decades.\textsuperscript{555} The true toll of the earthquake may never be fully known; however, it is estimated by Chinese state officials that the quake caused 69,181 deaths including 68,636 in Sichuan province. Further, 18,498 people are listed as missing, and 374,171 were injured. The earthquake left at least five million people without housing, although the number could be as high as eleven million.\textsuperscript{556} One of the problems here lies with the change to home ownership in China where-by the individuals own their own homes and pay monthly mortgage repayments on them. ‘The earthquake destroyed hundreds of thousands of houses. Although those houses collapsed, the quake-affected people still need to pay off their mortgages according to the law.’\textsuperscript{557} There needs to be a comprehensive system to deal effectively with the discharge of the debts of people who had uninsured properties and now have no home and do not have the ability to purchase a new home as they still have the financial obligations of the one that was destroyed.

Most recently, one Chinese lawmaker, Shi Ying, a deputy to the Chinese National People’s Congress, submitted a bill to the NPC that was in session of March 2009. She has called for the establishment of a personal bankruptcy system for victims of the earthquakes in Sichuan Province. In an interview, she lamented the difficult situations of some of the victims because they are still responsible for their mortgages even though the earthquakes have demolished their houses or apartments. She states, ‘if there is a personal insolvency system, we can declare someone is bankruptcy according to a fixed standard. And the bank can take all his or her assets except minimal living necessities for

the family, and the debt is thus cleared’. It is thought that since the loss of their homes and belongings was due to a natural disaster, then it would be unreasonable for victims of the earthquake to be liable for payment of mortgages and loans for property that no longer exist. Banks and lenders have been actively pursuing payment on these properties.

As consumer credit becomes easier to obtain and the increase of litigation resulting in financial awards against individuals has increased, it is natural that there will also be an increase of the burden of debt upon individuals. Having unlimited personal liability has extended the range of negative social issues. For example, a young college girl from a poor family was ordered by the People’s Court to pay a sum of money that she will never be able to pay to a victim that was injured by a fire that she accidentally started. The lack of a personal bankruptcy system has not only hindered her with a ‘life sentence’ of debt, but also has affected her ability to get married, since few men would be willing to marry a woman with a debt that she will be paying for the rest of her life. If the individual was a citizen of a country that had a personal insolvency regime, they would qualify for a release of that debt as they had no means to pay. In these kinds of instances, only the Chinese Civil Procedure Law is effective and the debt will continue to follow the debtor.

A recent decision by the SPC has now ruled that consumers using mainland credit cards, including those from Hong Kong, could be jailed if they default on credit card debts to

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559 Ibid.
mainland banks three months after receiving the second warning. Credit card crime is a rising problem within China with fraud and illegal cash withdrawals taking the majority of prosecuted cases. This new decision by the SPC has the potential to set a precedent for the prosecution of individuals that have real debt problems and can be included under these general provisions. If the individual knows they have no ability to repay the debt, the penalty can run from a RMB 20,000 fine for an overdrawn amount of more than RMB 10,000 and a life sentence for overdrawn amounts over RMB 1 million. Professor Li noted in the article that ‘the use of criminal charges puts all the responsibility on the consumers, whereas this problem could have been resolved through better civil law regulations on the lenders side’.

The notion that Asia represents a huge domestic consumption story is hardly new: Marco Polo had designs on it in 1271. It has been a ‘big idea’ waiting to happen for centuries, based on the sheer size of the Asian population basis. There is ample evidence that Asians (with the exemption of Hong Kong and Japan) feel confident about their prospects and are embarking on consumption and a lifestyle that strongly echoes the US Baby Boom Era. The Asia-US baby boomer parallel is based largely on the common aspiration of individuals living their lives in a world of higher personal confidence, job security and future optimism. However, it is important to note that the basis of the economies is different from that of the US. The ‘New Economy Technology’ stock market bubble in 2000 was one of the first indicators of US macro-economic imbalances. The Global Financial Crisis originating in American banks and resulting

561 Ng Tzi-wei Pay Off Cards Or Go To Jail: Beijing (2009) South China Morning Post <http://www.scmp.com/portal/site/SCMP/menuitem.2af62e6eb329d3d7733492d9253a0a0a0/?vgnextoid=3b6db6c070395210VgnVCM100000360a0a0aRCRD&ss=s=Home> at 16 December 2009.
562 Ibid.
564 Ibid, 2.
565 Ibid, 3.
in the largest corporate bankruptcies and collapses ever recorded highlights this. It is simply illogical to assume that the US consumer can continue to be the primary driver of global growth in the coming years.\textsuperscript{566} It is a safe assumption that Asia, and especially China, will be the centre for global economic consumer growth since Asia’s population has the savings to spend and more importantly, it has a significantly large population.\textsuperscript{567}

The economic reforms since 1978 have created a marked-oriented economy in China while the government still plays an important role in the central structure of the nation. With decades of economic growth, stable incomes, falling birth rates and household sizes, China is following most of Asia into a consumer revolution.\textsuperscript{568} For example, many of China’s newly affluent consumers are in their late 30s and 40s and are beneficiaries of economic liberalisation and a rapidly growing economy.\textsuperscript{569} It is not a question of spending more on existing goods and services but also being prepared to buy a far wider range of goods and services. The Asian consumers that have just now begun to spend on themselves and their lifestyles will continue to do so for the next 20 years, based on demographics.\textsuperscript{570} Just as the US Baby Boomers departed from the thrifty habits of their parents who were brought up during the Great Depression of the 1930s, the Asians will increasingly want more things now, whereas their parents preferred to defer purchases and save. This parsimonious attitude was further encouraged by Asian governments promoting high savings rates to finance export drives.\textsuperscript{571}

\textsuperscript{566} Ibid.
\textsuperscript{567} Ibid, 4.
\textsuperscript{569} Gary Coull, Asia’s Billion Boomers (2002) CLSA 2.
\textsuperscript{570} Ibid, 6.
\textsuperscript{571} Ibid.
To facilitate the growth of consumer finance, the People’s Bank of China has put into place a series of credit policies. Regulations such as ‘Management Measures on Individual Housing Loans’ (1998), ‘Management Measures on Auto Loans’ (1998), ‘Options on Consumer Credit’ (1999), ‘Administrative Rules for Automotive Loans’ (2004) have been implemented by the People’s Bank to regulate the financial structure and facilitate this growth.

The growth of consumer loans, mainly those for houses, has grown at a staggering rate. In July 1998, the welfare distribution of houses ended in China, placing all housing units on the market for sale. Individuals were now able to purchase their own home and buy and sell if they desired. China’s outstanding residential mortgage loans increased 142 times from 1997 to 2007 (64 per cent per year increase), to reach a total of RMB 2.7 trillion at the end of 2007. Total loans to consumers including mortgages reached RMB 3.28 trillion at the end of 2007, an increase of RMB 3.14 trillion from the level at the end of 1999. The proportion of consumer loans compared to total loans outstanding in total RMB bank loans in China rose 12.5 per cent at the end of 2007, from 1.5 per cent in 1999. Car loans grew quickly from 2001 to 2003 and slowed significantly in the beginning of 2004. There was a high default rate of car loans, which slowed new financing. In 2008, however, new car sales in China were 9.38 million units and it is expected that in 2009 that Chinese automobile sales will exceed those of the US.

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575 Ibid.
576 Ibid, 54.
Despite these recent growth rates, the consumer credit market is still in its infancy. Recent studies have shown that in some major urban centres, the percentage of residents have used consumer credit is below 20 per cent. This indicates that over half the urban population has no intention of purchasing on consumer credit. The People’s Bank of China has put in place a series of initiatives to expand consumer credit and bring the banks’ mix of consumer credit loans to a higher standard that is in line with bank lending in other developed countries. These initiatives have been highlighted as unpaid credit card debt has surged 126.5 per cent in the year ending September 2009. This phenomenon has prompted Beijing to warn banks to ease back on aggressive marketing. ‘The default rate is set to jump since all banks are gearing up to expand the high yield, while risky business. The rapid pace of credit card issuance will continue as banks vie for a big market share.’

The Government leaders realised, that based on the difficult lessons of the past that peoples’ living standards had to be raised, together with the development of productivity, otherwise, the merits of socialism over capitalism would not be apparent. In 1997, the Asian financial crisis affected China and it decreased retail sales for 24 consecutive months and caused nineteen months of reductions in the consumer price index. The Government provided a stimulus to increase consumer spending by decreasing the interest rates in banks to decrease saving, thus increasing spending. In 1999, it also introduced a new tax on interest earned from bank deposits and created three one-week...

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579 Daniel Ren, Mainland Credit Card Debts Surges (2009) South China Morning Post < http://www.scmp.com/portal/site/SCMP/menuitem.2af62ecb329d3d7733492d9253a0a0a0/?vgnextoid=b3d9d5d6bf545210VgnVCM100000360a0a0RCRD&ss=&s=Home> at 2 December 2009.
580 Ibid.
long holidays that would increase consumer consumption through spending and travel. The deputy director of the State Statistical Bureau, Qiu Ziaohua stated that in order for the Chinese economy to continue its annual growth rate of over seven per cent, there must be more domestic consumption to offset the decline in the export of Chinese goods. He called the domestic consumers ‘the new engines of the national economy’. The three most important issues here are the under-development of the rural consumer market, the polarisation of social wealth and the uncertainties of legal reform. These matters are now summarised: 1) The rural economy is falling behind the rest of the nation as far as real GDP economic output. In addition, inequality is still acute both between regions and between the rich and the poor. Between 2001 and 2006, the poorest ten per cent of households in China saw a reduction in their average annual disposable income from US$546 to US$420 whilst the richest enjoyed a massive increase from US$6,836 to US$13,122. These numbers are still above the US$1 a day poverty line as described by the World Bank, but there are still an estimated 130 million people at this level. Looking back on historical data, there was an estimated 84 per cent of the population of China in 1981 that was living below the poverty line. It is essential that this gap does not widen further and the lowest income families and individuals need an economic stimulus to increase their purchasing power and bring them above the poverty line. 2) The polarisation of wealth has been most evident within the large coastal cities on the eastern coast such as Shanghai, Beijing, Guangzhou and Shenzhen, which were the first to experience market-oriented reforms over the past 30 years and this has left most of the rural countryside and smaller regional cities behind in economic growth. This creates massive social inequality across a wide range of people and separates the classes of poor

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582 Ibid, 108.
583 Ibid.
585 Ibid.
and wealthy even further. Due to the high concentration of social wealth, the lowering of interest rates does not stimulate spending and cannot affect the behaviour of most consumers.\textsuperscript{587} It was estimated in 1999 that 66 per cent of all bank deposits were held by less than ten per cent of the population.\textsuperscript{588}

**Solution:** Economic reform over the past ten years has progressed at a rapid pace; however, there are still some concerns about the reform of markets and the effect government will have upon it. With the recent 2001 WTO accession, China has made great strides in developing an economic system that is on par with global financial and trade systems. With the change to a socialist market economy, it has been placing more responsibility in the hands of private enterprise. Housing, medical services, education and retirement services have become the responsibility of employers, thus decreasing the effectiveness of the socialist safety net.\textsuperscript{589}

The evidence from a simplified administrative system, such as the No-Asset Procedure that has been successfully introduced into New Zealand, has proven that dealing with smaller claims in which the debtor has next to no assets or savings is an effective mechanism in discharging the debtor from the debt. An administrative system such as this may be an effective tool for China to implement in dealing with small debts. It could be highly effective as it is more cost and time effective and would not burden the Courts with the numerous claims made for a traditional bankruptcy proceeding.


\textsuperscript{588} Ibid.

\textsuperscript{589} Ibid.
Other recommendations for features of how a system may work include a sliding scale for length of time before discharge from three to ten years based on the debtor’s age. The younger the debtor, the more time he or she would spend in bankruptcy and make partial repayments to creditors. If the debt is paid in full within this time, then the debtor would be discharged.\textsuperscript{590} This would be a unique feature for China that would help maintain social stability.

The implementation of a system of limited personal bankruptcy that would have specific tests to a limited number of people would be a good test for a social experiment in personal bankruptcy in China — much like the early 1986 Bankruptcy Law and special regulations that were passed in certain economic zones and regions in the mid-1980s. If the Chinese government was to introduce a trial personal bankruptcy system, it could use this model to refine a system that could possibly be rolled out on a national level. Such trial implementation can be modified as different requirements are discovered and this would provide the Chinese people with a system that would provide effective relief on a personal level.\textsuperscript{591}

With unprecedented growth rates in China of consumer credit, it is only a matter of time before China will be forced to readdress this issue. As the effects of the current Global Economic Crisis have not yet been fully realised, there is mounting pressure on legislators to review the reform of personal insolvency laws. This will have a direct effect on the Chinese economy, as millions of jobs may be lost and economic trade may

\textsuperscript{590} Personal conversation with Professor Wang Weigou, Dean of the School of Civil, Commercial and Economic Law, China University of Politics and Law (Beijing, 8 October 2009).

be brought to a standstill. Experience in Asia has demonstrated that it is better to enact bankruptcy laws before they are perceived to be needed rather than in times of crisis.592

Since the adoption of economic reforms and the “opening-up” policy of the late 1970s, China has undergone enormous economic changes. Its emergence as a world industrial and economic power is one of the most significant global developments of the past 30 years. Rapid economic development has irreversibly altered international trade and investment at the global level. At the same time, there has been a rapid adoption of commercial laws and numerous updates and revisions across all ranges of commercial law within China. The first bankruptcy law was largely a first attempt to deal with distressed state-owned assets. Now with the EBL in place, there is functioning legislation for all legal person enterprises that will assist the economic growth in China.

The Global Financial Crisis has highlighted the need for a modern and proper functioning bankruptcy system. As recent evidence from the GFC has shown, without corporate rescue laws in the US and other Western countries, the fallout could have been much worse as government bailouts would not have been able to function. Reorganisation of some of the world’s largest companies would have ended in liquidation, placing the jobs of millions of people at risk and a possible collapse of the financial system. China now possesses a corporate rescue mechanism under Chapter 8 of the EBL that will allow the reorganisation of companies in this fashion. The development of these laws is critical, for China’s continued economic growth and reforms.

A discussion of the development of bankruptcy law in China was provided. From imperial times, the repayment of debts was paramount and families were required to pay...
the debts of their ancestors. Western governments first passed commercial bankruptcy laws in the mid-1800s in the UK. In 1906, China enacted its first commercial bankruptcy law. Because of the policies of the Chinese Communist Party under the leadership of Chairman Mao there was little need for economic laws. When the opening-up policies in the 1978 took effect, China’s development in this area lagged behind the Western world.

The 1986 Bankruptcy Law was China’s first attempt at a bankruptcy regime that moved away from the norms of a socialist centrally planned economy. Used for the reorganisation of SOEs, it was effective as a mechanism for planned bankruptcies by the SASAC. As additional regulations came into place in the early 1990s, this legislation was able to deal with a great number of cases allowing the reorganisation of SOEs and effectively dealt with workers resettlement and social security issues.

There was still a need for a modern and effective bankruptcy law that allowed the Courts to deal with these cases and all enterprises within China. The drafting of the 2006 EBL took twelve years resulting in a technically effective law based on civil law traditions that is uniquely ‘Made in China’.

An analysis of the 2006 EBL addressed issues of how the law applied to enterprises, tests and applications of bankruptcy, the role of the administrator, security rights, creditors’ rights, corporate restructuring and cross-border bankruptcy issues. A review of the academic analysis of the law resulted in the identification in various problems. Some of the issues have been resolved in the form of directions from the SPC but some of the problems have contributed to the overall problems with the bankruptcy regime.
Explanations of problems within the Chinese bankruptcy regime from the view of a foreign creditor were highlighted. When initiating proceedings or participating in a Chinese bankruptcy, there are numerous and unforeseen problems and challenges. These issues are divided into two categories: practice and law.

The overriding problem in practice is the lack of a bankruptcy infrastructure within China. A bankruptcy department as its own government department is required to provide the mechanism for the proper administration of the law. This department would have the ability to make regulations and amendments to the law, issue insurance for directors, act as public administrator and create an administrators association as a new professional body in China. This would result in a more comprehensive and functioning system that would produce an even result from jurisdiction to jurisdiction.

The Western world has always questioned the ability of a Chinese court to render a fair and impartial judgment. In many commercial matters, the Courts are said to be impartial. However, given existing issues of adverse influence from local governments and other parties, a foreign creditor may not be able to rely on the Court for an impartial judgment.

The development of special bankruptcy Courts and the use of special bankruptcy judges, as it is commonplace in many Western bankruptcy regimes, would increase understanding and result in more predicable judgments and a more effective bankruptcy system. Since bankruptcy is such a diverse practice touching on many aspects of law across the legal spectrum, a central system that is specially designed for dealing with bankruptcy cases would be of great assistance to the Chinese bankruptcy regime.
Some foreign creditors encounter issues when dealing with a Chinese bankruptcy that are foreign to the western world where the rule of law governs the proceedings. The influence of Courts and local government officials in doing what they think is best for ‘the enterprise’ is not necessarily what the law states. The age-old trick of ‘detaining’ is still prevalent and foreign creditors must be aware of the risks.

With foreign investment in China decreasing during the Global Financial Crisis, existing deals, such as pre-IPOs and other direct investment, have resulted in billions of dollars in investment being placed into question. Converting assets into cash and recovering money from distressed investments continues to be a challenge and this has changed the risk appetite of foreign creditors.

One of the chief issues when considering cross-border insolvency is the recognition of bankruptcy proceedings both in and out-bound. Even though Article 5 of the EBL uses the principles of universality, there have been no major cases yet to prove that it is an effective law. Any cases that have come up have either been very small, unreported or they are dealt with in a foreign jurisdiction such as Hong Kong or the US. In theory, there should be no problems with the implementation of cross-border recognition but there is an apparent danger in being the test case. As time progresses, there will no doubt be such cases, and further guidance can be given at that time.

Creditors still lack of rights in dealing with a bankruptcy case. As discussed, they are somewhat restricted compared to Western bankruptcy regimes from investing additional monies and providing direction that could assist the enterprise and result in a higher
recovery for the creditors. The stay of proceedings is an additional issue. It is restrictive for creditors and additional flexibility would result in successful returns to creditors.

The SASAC is still processing policy bankruptcies and this is affecting practice and the law. These policy bankruptcies should be finished soon, and then all bankruptcy proceedings will be governed in the same manner and equality among enterprises might be achieved.

Corporate governance issues are still being resolved and increased governance in Chinese enterprises is needed. This will no doubt be a long process, as many business and cultural issues must be overcome to have a ‘good’ governance system. This problem also relates to issues such as the legal representative and the outdated tradition of the company chop. Changes in the way that the legal authority of the company is executed must be reviewed in order to bring it into line with international best practice.

There is still a need for the expansion of bankruptcy law to include non-legal persons and individuals. Infrastructure and education must first be put into place to handle such cases, before this could be implemented. Foreign creditors must be aware of the additional associated risks as there could be additional exposure to debts being cancelled in the bankruptcy process.

Lastly, there is an apparent need for the continued education of lawyers, judges, administrators, businesspersons and government officials. Once the negative connotations of bankruptcy are dealt with, it will be realised that reorganisation can be a positive thing. This is bound to come with time, experience and education.
The selected case studies have shown that the practice of bankruptcy is still in its infancy and there has been a lack of cross-border cases and cases with substantial foreign creditors. Due to the above-mentioned problems, foreign creditors have been reluctant to use the process and have used other methods in settling the problem. As time passes, there will no doubt be additional cases that will provide a better understanding of and guidance for the effectiveness of the EBL. Until this happens, creditors are being wary of being the first real ‘test case’ and would prefer to deal with the matter in a different forum.

It may have taken twelve years to sharpen the sword of bankruptcy in the development of the 2006 EBL; however, while the sword may now be sharp, the problems with infrastructure, law, policy and practice are still prevalent, thus blunting its effectiveness. The bankruptcy regime does not provide foreign creditors adequate protection, thus leaving a substantial risk to investment or issuing credit in China. Foreign creditors should be aware of these risks and mitigate them accordingly as the EBL does not afford them sufficient protection.
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