

China's Enterprise Bankruptcy Law, Building an Infrastructure

Towards a Market-Based Approach

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China has long been under external pressure to develop a market-based approach to bankruptcies and reduce state involvement in such cases. The enactment of the Enterprise Bankruptcy Law 2006 was an important first step in this regard but laws are insufficient in themselves and this Act has given rise to a very low number of cases, attributed in part to ongoing state influence. This paper examines the reasons for the law's limited impact, paying particular attention to the role of the state, which appears to be changing.

Introduction

The enactment of the Enterprise Bankruptcy Law in 2006 was a significant legal development in China. It was necessitated by both internal and external political and economic pressures and its impacts were potentially major, not only in addressing these pressures, but also legally and culturally. Hitherto, bankruptcies had been tightly controlled and state-driven alternatives were preferred and the economy was not yet ready to transition to a solely market-driven, rather than state-driven, system of bankruptcies in view of the possible social impact.¹ Nor was the new law sufficient in itself, as a bankruptcy law requires

¹ See further Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 JCLS 113.

skilled and experienced judges and practitioners and these needed to be developed if numbers of formal bankruptcies were to be supported.² These conditions limited the law's impact, as is statistically evident over ten years on. As might have been anticipated, the operation of the bankruptcy law in practice has been complex but there are signs that the system³ is inching towards a more market-based approach, as still necessitated by internal and external factors,⁴ and the legal system and institutions are developing to support this. This paper will consider the first ten years of this law with a view to assessing how far the law has operated according to market conditions and will consider the possible future development of the bankruptcy law and legal system as China's economy continues to grow and evolve. A central aim is to assess the extent to which China's insolvency laws are operating according to market-based principles, free from state administrative direction. Firstly, the concept of a market-based bankruptcy will be framed and categorised, identifying that economies typically do not wholly rely on market-based formal bankruptcies to resolve the problems of distressed companies. While liquidations in market economies tend to be done according to formal procedures, market-based rescues are often done outside of the formal rescue procedures, even in established systems, and collective approaches are only used where rescues outside the formal framework fail. Therefore, a low number of formal cases is not necessarily evidence of a lack of a market-based approach, or a lack of a rescue culture. The background

² Jingxia Shi, '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, 645.

³ In reality, rates of progress differ significantly across China as a whole. Some cities are becoming more advanced towards market-based bankruptcy reforms: see Stacey Steele et al, 'Trends and Developments in Chinese Insolvency Law: the First Decade of the PRC Enterprise Bankruptcy Law' (2018) 66 *The American Journal of Comparative Law* 669.

⁴ See for example the United States Trade Representative, '2016 Report to Congress On China's WTO Compliance', 5 discussing the need for an impartial bankruptcy system.

to the new Chinese law will then be briefly considered before a thematic functional analysis of the law in practice will be offered with a view to identifying key factors in the move to market-based, rather than state-directed bankruptcies, while also identifying areas in which progress is still to be made. The operation of the law in the first ten years will be considered with a view to assessing how far the law is operating according to market principles, identifying that there are various factors at play in leading to a low number of cases but that the infrastructure to support market-based cases is being built and there is some evidence to indicate that state influence is transforming to support this. Finally the paper will reflect on possible ways in which the laws might develop in future.

Insolvencies in Market Conditions

Firstly, what is meant by a market-based insolvency and what by state-driven? Arguably economies typically tend to feature insolvencies of both types and there are three common approaches, representing relative degrees of influence of the market and the state. Firstly there are cases where the market can effectively rescue distressed businesses without the need for state assistance in the form of statutory formal insolvency proceedings, in what are commonly termed “informal” workouts or restructuring proceedings and which may also, more accurately, be termed as an “individualistic market-based” approach, since what is lacking is a formal mechanism for collective negotiation with and treatment of creditors but the dealings with individual creditors have individual formality, based in contract law with the court as a potential arbiter.⁵ Arguably the term “informal” fails to reflect these and other

⁵ Studies from various jurisdictions of the factors that impact upon the decision to pursue informal resolution include Stuart C Gilson, Kose John, Larry HP Lang, ‘Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default’, (1990) 27(2) *Journal of Financial Economics* 315; Philipp Jostarndt and Zacharias Sautner; ‘Out-of-Court Restructuring versus Formal Bankruptcy in a Non-Interventionist

nuances. Secondly there are those where collective proceedings are needed with controls on individual actions by creditors. This approach is of benefit inter alia in cases where individualistic market-based dealings, which lack controls on creditor actions and means for majority voting or cramdowns, are insufficient to resolve the financial distress. In this context, the role of the state is confined to providing a legislative framework and the rule of law to enforce it, an approach which may be termed as “collective market-based”. Such an approach will tend to offer advantages through restriction of the entitlements of creditors, since creditors may be restricted from e.g. suing the debtor or repossessing goods, as they would otherwise be able to,⁶ and the reaching of a negotiated agreement for the payment of debts is assisted by a requirement of only majority, rather than unanimous, approval for a restructuring plan.⁷ Thirdly, there are cases where more direct state action is necessitated, due the socially important nature of the struggling enterprise, and this “state-driven” approach may be helpful in cases where the collective market-based approach is insufficient, for reasons of scale or technicality, for example, or where there is a lack of support or consensus among creditors. The extent to which these approaches can operate without persuasion from the state can be regarded as a measure of the extent to which the insolvency system as a whole is market-based.

Bankruptcy Setting’ (2010) 14(4) *Review of Finance* 623; Michael Jacobs, Ahmet K Karagozoglu and Dina Naples Layish, ‘Resolution of Corporate Financial Distress: An Empirical Analysis of Processes and Outcomes’ (2012) 38(2) *Journal of Portfolio Management* 117; Régis Blazy, Jocelyn Martel and Nirjhar Nigam, ‘The Choice between Informal and Formal Restructuring: The Case of French Banks Facing Distressed SMEs’ (2014) 44 *Journal of Banking and Finance* 248; Naohisa Goto, Konari Uchida, ‘How do banks resolve firms’ financial distress? Evidence from Japan’ (2012) 38 *Rev Quant Finan Acc* 455.

⁶ UNCITRAL, *UNCITRAL Legislative Guide on Insolvency Law* (2005), 83.

⁷ UNCITRAL, *UNCITRAL Legislative Guide on Insolvency Law* (2005), 217-227.

Looking at these issues more closely, attention in insolvency law literature is often focused on the second approach above of collective market-based proceedings, such as under the US Code, Title 11 and the UK Insolvency Act 1986. It is identified that a competitive market place will naturally lead to the failure of some businesses and the success of others.⁸ In theory if the competitive market works perfectly those enterprises which are inefficient will be eliminated from the market, leading to a situation in which the remaining enterprises are those who produce at optimal levels of cost.⁹ As part of most developed systems, firms which are facing temporary difficulties may be given protection in a reorganisation procedure through an automatic stay to enable them to resolve their problems without pressure from creditors.¹⁰ Here the state permits some distortion of market forces through restriction, under statutory provisions, of the entitlements of creditors, for example to take action to request payment, repossess property, or sue, leading to what may be termed a “collective market-based” approach. This distortion is entertained in view of the potentially greater

⁸ Eckart Ehlers, ‘German Statutory Corporate Rescue Proceedings: the *Insolvenzplan* Procedure’ in Katarzyna Gromek-Broc and Rebecca Parry (eds), *Corporate Rescue: An Overview of Recent Developments from Selected Countries in Europe* (Kluwer 2004), 79-80.

⁹ Michelle White, ‘The Corporate Bankruptcy Decision’ (1989) 3 *Journal of Economic Perspectives* 129. The idea that bankruptcy acts as a screening process which will remove inefficient enterprises from the market and enable their resources to be more productively deployed is modified somewhat in practice. The decision as to whether to pursue liquidation or reorganisation proceedings may be in the hands of the debtor and this can create distortions, such as where directors delay filing and miss out on any viable reorganisation opportunity. However creditors may lack information that would enable them to identify the financial difficulties at an earlier stage and they may lack incentives to take action. See further below for the impact of these factors in Chinese insolvencies.

¹⁰ See e.g. EBL 2002, Arts 20 and 21; US Code, Title 11, s 362; Insolvency Act 1986, Sch A1 and Sch B1, paras 42-44.

macroeconomic benefit of assisting struggling but viable companies, or their underlying businesses, to recover from temporary financial distress.¹¹ A successful reorganisation can minimise the social costs of the company's financial distress, avoiding job losses, which potentially give rise to wastages of knowledge, skills and experience, and could have devastating impacts on local communities, and result in losses to creditors, loss of tax revenue, and potential knock on impacts on customers and suppliers. The business is also potentially more valuable if kept intact.¹² Such distortions are in part entertained in the interests of creditors in order that the estate can be preserved and possibly augmented prior to liquidation and the company itself will not be saved. The ability to separate valuable assets from the company's liabilities may mean that business sales will be preferred to company sales unless there is some inalienable asset, such as a license, held by the company.¹³ In particularly significant cases with potentially high social costs the state may play the leading role rather than the market, as discussed in relation to the third, state-driven, approach and this is the approach that dominated in China in the years following the commencement of the reform and opening up policy,¹⁴ with a preference to handle such cases through absorbing the

¹¹ It is notable that there has been a trend towards business sales in the US, through section 363 sales, and the UK, through prepacks. See also Stephan Madaus, 'Reconsidering the Shareholder's Role in Corporate Reorganisations under Insolvency Law' (2013) 22 Int Insolv Rev 106, noting a German trend.

¹² An exception arises in the event of economic distress, where the business will raise more value if broken up and its assets sold individually, than it would be if the assets were kept together.

¹³ As discussed below, uneconomic companies in China have been saved in cases where they might not otherwise have been saved, as they have held non-assignable licenses.

¹⁴ Henry R Zheng, 'Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice.' (1986) 19(4) Vand J Transnat'l L 683, 685-6; Sheryl Miller, 'Institutional Impediments to the Enforcement of China's Bankruptcy Laws.' (1996) 8(2) Int'l Legal Persp 187, 190.

assets of failing enterprises into productive enterprises, through mergers, rather than through liquidations.¹⁵

It is also particularly notable that in a market-based system the market itself may provide a solution to financial distress, even without a statutory insolvency collective framework under the “individualistic market-based” approach. The market can act by facilitating an informal rescue or turnaround, for example by enabling the company to gain finance and to reach a compromise with creditors on the basis of contractual bargaining. Such bargaining may be done individually, through contract, or collectively either by creditor consensus¹⁶ or by the use of a compromise framework, such as a scheme of arrangement.¹⁷ Investors may enable a company to reorganise through ceding entitlements.¹⁸ Creditors may be willing to agree to a renegotiation if this is in their individual self-interest, for example to preserve a working relationship or if returns are likely to be higher than they would be in liquidation. Such consensual renegotiation, if supported by sufficient creditors, may limit the need for

¹⁵ Shuguang Li, ‘Bankruptcy Law in China: Lessons of the Past Twelve Years’ (Winter 2001) V

Harvard Asia Quarterly 1. An example is Sichuan Joint-Wit Medical, discussed in Amy Kam, David Citron and Gulnur Muradoglu, ‘Distress and Restructuring in China: Does Ownership Matter?’ (2008) 19 *China Economic Review* 567, 579.

¹⁶ A notable example is the London Approach. See John Armour and Simon Deakin, ‘Norms in Private Insolvency: The “London Approach” to the Resolution of Financial Distress’ (2001) 1 *Journal of Corporate Law Studies* 21-51.

¹⁷ Companies Act 2006, s 895. The US prepackaged restructuring plan, for which creditor support is gathered in advance of a Chapter 11 filing, may be regarded as another example of creditor compromise.

¹⁸ A move which failed in the Rickmers case <<https://www.reuters.com/article/rickmers-restructuring-bankruptcy/shipping-group-rickmers-to-file-for-insolvency-as-revamp-fails-idUSASN0007GC>>, accessed 17 January 2019.

collective market restricting interventions.¹⁹ So successful have these individualistic market-based rescues been in markets that work well that in many instances the enterprises that end up in collective proceedings are effectively non-viable “lame ducks” that could not be saved outside the formal framework.²⁰ In such cases the collective proceedings are used merely to achieve higher returns in a sale of the company’s underlying business, or dispersal sale of assets in a break-up sale. It is rare that the company is sufficiently viable to merit a trading reorganisation, in which the company enjoys a period of protection from the claims of creditors and, at the end of this proposes a plan for continued trading. Such an ongoing trading approach, is often regarded as too expensive and time consuming in contrast to a quick business sale, and it can be that companies are only saved in cases where there are regulatory reasons for doing so.²¹ Bankruptcy statistics therefore tell only part of the story and it is important to have regard to what is happening beyond the application of formal insolvency proceedings.

As will be outlined below, the state has tended to play a central role in relation to distressed enterprises in China, notably at local government levels, and this is therefore a markedly different approach from that envisaged in many market economies, where the state tends to

¹⁹ Paul Omar ‘The convergence of creditor-driven and formal insolvency models’ (2005) 2 International Corporate Rescue 251.

²⁰ See Sandra Frisby, ‘Report to the Insolvency Service: Insolvency Outcomes’ (Insolvency Service June 2006); Rebecca Parry, ‘Is UK Insolvency Law Failing Struggling Companies’ (2009) 18(2) Nottingham Law Journal 42, 44.

²¹ For example, a non-transferable license, such as an Air Operator Certificate. A football club company may kept going for example in order to retain the contracts of playing staff and the league registration: *Re Wolverhampton Wanderers Football Club (1982) Limited* 1986 WL 1255425. See also Ed Horton, *Moving the Goalposts* (Mainstream Publishing 1997), 137.

leave it to the market to take care of the fallout under either individualistic or collective market-based approaches.²² The potential for a state-driven approach increases where the likely social costs of an insolvency are high. There may be such an approach if state bailout finance is granted to enterprises that are regarded as too important to fail, either on account of systemic risk or social importance.²³ Such interventions may enable the recovery of the enterprise to be achieved and the cost of doing so to be spread within society.²⁴ However bailouts are criticised where they are awarded on the basis of non-market criteria and artificially prolong the existence of unviable enterprises.²⁵ Rather than the future of the enterprise being in the hands of creditors, or a neutral judge, decisions are political, which can lead to an inefficient allocation of resources and to future moral hazard problems. An approach whereby the state picks up the functions of the enterprise, so far as the market does

²² See also Michael Bridge & Jo Braithwaite, 'Private Law and Financial Crises' (2013) 13 *Journal of Corporate Law Studies* 361 (discussions of various self-help approaches by parties to financial transactions that have enabled financial markets to weather crises).

²³ Shlomit Azgad-Tromer, 'Too Important to Fail: Bankruptcy Versus Bailout of Socially Important Non-Financial Institutions' (2017) 7 *Harvard Business Law Review* 159, discussing responses to financially distressed companies which perform essential social functions, the failure of which would give rise to public concern. .

²⁴ Dylan J DelliSanti and Richard E Wagner, 'Bankruptcies, Bailouts, and Some Political Economy of Corporate Reorganization' (2018) 14 *Journal of Institutional Economics* 833. For efforts to design a model for bailouts that minimises distortions see Antonio E Bernardo, Eric L Talley and Ivo Welch, 'Designing Corporate Bailouts,' (2016) 59 *The Journal of Law and Economics* 75, noting the difficulty of avoiding bailouts where an enterprise is systemically significant.

²⁵ Huimiao Zhao, 'Reorganization of Listed Companies with Chinese Characteristics' (2017) *Am Bankr LJ* 87,119-120. A critical approach to restructuring aid is taken in the European Union, as explained in 'Communication from the Commission — Guidelines on State aid for rescuing and restructuring non-financial undertakings in difficulty' OJ C 249, 31.7.2014, para 5-13.

not, and leaves the company to fail may be preferable.²⁶ This is an aspect in respect of which the Chinese approach has tended to differ markedly. The state has played a central role in China's transition to a market economy and consequently the state adopted a necessarily cautious approach to the treatment of non-viable SOEs,²⁷ partly through concerns regarding devastating social costs in a society without a developed social security system, and alternatives such as mergers have been preferred as a means for company difficulties to be addressed, rather than the shock of liquidation.²⁸ Reliance on this approach naturally led to path dependent tendencies for the state to remain involved in the resolution of bankruptcy cases after the 2006 law came into force. More recently efforts, particularly in chief economic centres, appear to be moving in a different direction.

Background to the 2006 law

The transition to China's version of a market economy²⁹ under the process of reform and opening up in the years following the death of Chairman Mao has necessarily been gradual, requiring the cautious and gradual abandonment of a traditional understanding of Communist ideologies regarding the criminalisation of private property, private business and

²⁶ Eva Hupkes 'Protect Functions not Institutions' (2004) 9 *The Financial Regulator* p 43; *Airline Insolvency Review – Interim Report* (July 2018), para 2.4.

²⁷ International Monetary Fund Press Release No 16/374, 'IMF Executive Board Concludes 2016 Article IV Consultation with the People's Republic of China', August 12, 2016

²⁸ Henry R Zheng, 'Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice.' (1986) 19(4) *Vand J Transnat'l L* 683, 686.

²⁹ A transition first announced at the Third Plenum of the Eleventh Central Committee of the Chinese Communist Party held in December 1978.

entrepreneurship.³⁰ The slow transformation of China, which is indeed ongoing, inevitably impacted upon efforts to introduce a modern bankruptcy law.³¹

One obstacle to the enactment of the 2006 Law was the significant number of uneconomic state-owned enterprises which had become inefficient through a lack of exposure to competitive market forces. 1998 statistics show that, at that time, SOEs provided four fifths of the outputs from the manufacturing sector and employed two thirds of the number of industrial employees.³² Yet, under the planned economy state owned enterprises were subject to government control, which inevitably led to the operation of the firms for political and social purposes (primarily non-profit seeking), without incentives for economic efficiency, such as budgetary constraints, and without exposure to market forces. In consequence, many were insolvent. The reform process in respect of SOEs was long and complex, involving processes of corporatisation, which improved the corporate governance and performance of SOEs³³ and mergers, which, were used to eliminate some enterprises.³⁴ There was only a limited role for liquidation, in the sense of a collective procedure for the

³⁰ For an examination of the phases of the transformation to a socialist market economy see Steven Rosenfield and Jonathan Leightner, *China's Market Communism* (Routledge 2018), 20-26.

³¹ See further Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 JCLS 113.

³² NR Lardy, *China's Unfinished Economic Revolution* (Washington DC, Brookings 1998), 25.

³³ Fang Liufang, 'China's Corporatization Experiment.' (1995) 5(2) Duke J Comp & Int'l L 149; Deborah K Johns, 'Reforming the State-Enterprise Property Relationship in the People's Republic of China: The Corporatization of State-Owned Enterprises.' (1995) 16(3) Mich J Int'l L 911

³⁴ Henry R Zheng, 'Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice.' (1986) 19(4) Vand J Transnat'l L 683, 686; Shuguang Li, 'Bankruptcy Law in China: Lessons of the Past Twelve Years' (Winter 2001) V Harvard Asia Quarterly 1

business exit and short-term liquidation of the debtor's estate and the distribution of assets among creditors.³⁵

Although a trial bankruptcy law had been introduced in 1986 in relation to state owned enterprises it was very far from being operated according to market principles.³⁶ There was an important loophole for public utility enterprises and enterprises with an important relationship to the economy and livelihoods.³⁷ The 1986 Law was also a law that provided for heavy state control of insolvency proceedings, in the form of a liquidation group, made up of local government officials and representatives from government agencies, such as concerning taxation.³⁸ In spite of large numbers of uneconomic state owned enterprises the number of cases brought under the Law was very low³⁹ and other means of dealing with such enterprises were preferred, so that the approach remained state-driven even after the prospect of a collective market-based approach to insolvencies emerged.

³⁵ Arnab Bhattacharjee and Jie Han, 'Financial Distress of Chinese Firms: Microeconomic, Macroeconomic and Institutional Influences' (2014) 30 *China Economic Review* 244, 245.

³⁶ On the background to the 1986 Law see Ta-Kuang Chang, 'The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process' (1987) 28 *Harvard International Law Journal* 333; Jingxia Shi, '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.

³⁷ Law of the People's Republic of China on Enterprise Bankruptcy (For Trial Implementation)(1986), Art 3(1).

³⁸ Law of the People's Republic of China on Enterprise Bankruptcy (For Trial Implementation)(1986), Art 24; Huimiao Zhao, 'Reorganization of Listed Companies with Chinese Characteristics' (2017) *Am Bankr LJ* 87, 120.

³⁹ See statistics in Rebecca Parry and Haizheng Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *JCLS* 113, 116.

China is a country of uneven economic development⁴⁰ and some regions moved fairly rapidly towards market economies, leading to differing paths towards market-based bankruptcies. Accordingly, some more advanced regional insolvency laws developed.⁴¹ There were also legislative and organisational developments at national level. The civil law enabled the liquidation of private enterprises, although not their reorganisation.⁴² The State-owned Assets Supervision and Administration Commission of the State Council, “SASAC”, a body responsible for managing the remaining SOEs, and through a process of merger and some insolvency procedures the number of SOEs has declined significantly, while economic performance was encouraged through budgetary constraints, state ownership levels were reduced and the status of SOEs in the economy was downgraded from a principal component to one pillar of the economy. The stated aim of the Chinese government is that SOEs will become independent market entities by 2020.⁴³

Over time, pressures to enact a new bankruptcy law grew, including external pressures. Upon joining the WTO in December 2001 China was expected to transition to a more

⁴⁰ The recent ‘one belt one road’ initiative will in part promote the greater development of China’s interior: Steven Rosenfield and Jonathan Leightner, *China’s Market Communism* (Routledge 2018), 29; Yu Jie, ‘China’s One Belt, One Road: a Reality Check’ LSE Ideas, Strategic Update 17.3 (July 2017), 3.

⁴¹ See further Roman Tomasic and Margaret Wang, ‘The Long March Towards China’s New Bankruptcy Law’, in Roman Tomasic (ed), *Insolvency Law in East Asia* (Ashgate 2006), 95-98. Documents issued by the state council also set out policies applicable in selected cities.

⁴² Civil Procedure Law 1991, chapter 19 containing insolvency laws applicable to non SOEs.

⁴³ State Council guidelines reported in Ben Bland ‘China plans shake-up of state-owned enterprises to boost growth’ *Financial Times* (London, September 13 2015)

market-based economy⁴⁴ and it has been subject to a multi-lateral peer review exercise every two years, while receiving praise for economic development there have been criticisms of market interference. The EU, Japan, US and other WTO members have been reluctant to regard China as having a market economy and this has led to tariffs on Chinese exports. The enactment of a modern and market-based bankruptcy law was a step towards the demonstration of a market economy, however it was enacted at a time when China was still at an early stage of its economic transformation and much has happened in the interim. Nonetheless the US and EU have continued to refuse to recognise China as having a market economy and the tariffs which have been applied by the US to Chinese imports as a result are the subject of a WTO dispute.⁴⁵

At the time when the law was going through the reform process the state was rightly concerned about the potential impact of an unrestrained application of a new bankruptcy law to liquidate large numbers of uneconomic state-owned enterprises.⁴⁶ This was a society of vastly differing levels of economic advancement in different regions and which lacked a developed social security infrastructure,⁴⁷ with SOEs providing equivalent lifelong benefits to employees. If SOEs were simply liquidated there would be no social safety net. Significant

⁴⁴ Accession obligations are discussed in Qingjiang Kong, 'China's WTO Accession: Commitments and Implications' (2000) 3 *Journal of International Economic Law* 655, with particular reference to the treatment of uneconomic SOEs at 676.

⁴⁵ WT/DS543, 'United States — Tariff Measures on Certain Goods from China' and WT/DS565, 'United States — Tariff Measures on Certain Goods from China II'.

⁴⁶ Jingxia Shi, '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.

⁴⁷ Henry R Zheng, 'Bankruptcy Law of the People's Republic of China: Principle, Procedure & Practice.' (1986) 19(4) *Vand J Transnat'l L* 683, 712-714.

numbers of market-driven bankruptcies could therefore have been disastrous in terms of social costs and there were fears of unrest. The legislative path for the 2006 law was accordingly far from smooth, with several stalled earlier attempts to enact a new bankruptcy law. Nonetheless factors such as the demands of China's external relations meant that the passage of this law could be resisted no longer. The 2006 law was promulgated on 27 August 2006 and entered into force on 1 June 2007 as a first step in the development of a mature system of insolvency laws.

Overview of the 2006 law

The 2006 law contained the features that might be expected of a modern, collective, market-based system of insolvency laws. Influences of insolvency systems in other countries are evident, following the extensive studies of the drafting team of insolvency laws in other countries.⁴⁸ This was not a copy/paste job, however, and the law adapted the provisions for the Chinese context. The new law was notably brief, consisting of only 136 articles, leaving inexperienced courts and practitioners with a limited framework from which to adapt to this approach to distressed enterprises, and it was subsequently augmented by Supreme Court guidance on matters such as the appointment and remuneration of administrators⁴⁹ and more recently through interpretative rules and case exemplars.⁵⁰ More recently, progress has also

⁴⁸ Bruce G Carruthers and Terrence C Halliday, 'Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes.' (2006) 31(3) *Law & Soc Inquiry* 521, 561-68.

⁴⁹ 'Regulations of the Supreme People's Court on the Appointment of Administrators for Hearings on Cases of Enterprise Bankruptcy', translated by Ted Wang, (2009) 42 *Chinese Law and Government* 85.

⁵⁰ Supreme People's Court, 'Ten Model Cases regarding Trial of Bankruptcy Cases according to the Law and Promotion of the Supply-Side Structural Reform' (15 June 2016) <<http://en.pkulaw.cn/display.aspx?cgid=a25051f3312b07f3e4c2d73206a7d1564df0ee829d4e892bbdfb&lib=case>>, accessed 9 June 2019

been made in identifying suitable approaches for case handling. In March 2018, the Supreme Court issued “The National-wide Bankruptcy Court Trial Work Conference Summary” (the Summary).⁵¹ The Summary was augmented in April 2018 through the explanations of Du,⁵² the Deputy Director of the Advisory Committee of the Supreme Court in relation to various matters of importance to current trial work.⁵³ Reference will be made below to the Summary and the guidance of Du, where relevant. It may be anticipated that more will be done in future to flesh out the legislative framework and more interpretative guidance can be anticipated. It might be expected that such guidance will be needed in particular for technical aspects of the law, such as cramdowns, as experience of the new law increases.⁵⁴

When we look at market-based insolvency systems we can expect to see formal collective procedures with two different aims: one being to promptly remove inefficient businesses

⁵¹ Supreme Court, ‘Minutes of the National Court Bankruptcy Trial Work Conference 4 March 2018’ <<http://www.court.gov.cn/zixun-xiangqing-83802.html> >, accessed 17 January 2019. The Summary covers eight areas: professionalisation of bankruptcy trials, perfection of the system of administrators, reorganisation, liquidation, affiliated enterprise bankruptcy, the connection between debt enforcement and bankruptcy, the establishment of a bankruptcy information network and cross-border bankruptcy.

⁵² Du Wanhua, ‘Ten Issues that Must be Grasped in the Current Bankruptcy Trial Work’ (4 April 2018, Beijing) People’s Court Daily <http://rmfyb.chinacourt.org/paper/images/2018-04/04/05/2018040405_pdf.pdf>, accessed 17 January 2019.

⁵³ These included bankruptcy of mutual insurance and joint guarantee companies; co-operation in cases with state involvement (discussed briefly below); and the desirability of development of summary approaches for simple cases.

⁵⁴ Daoning Zhang, ‘Cross-Class Cram-Down Mechanisms under Chinese Bankruptcy Law – Are Creditors Adequately Protected?’ presented at the Law, Finance and Development with Chinese Characteristics conference, jointly organised by University of Leeds School of Law at SOAS, 25 June 2019 notes that 28% of reorganisation cases involving listed companies involved cramdown.

from the market, through liquidation;⁵⁵ the other being to enable reorganisation of struggling but viable businesses through negotiation and agreement of a plan (even if the outcome for enterprises that enter reorganisation proceedings can be rather different).⁵⁶ Indeed the existence of a reorganisation law is regarded as one a “distinguishing feature” of a market economy,⁵⁷ based on the “persuasive power of ‘private ordering’” through negotiation rather than a judicial direction or adversarial process.⁵⁸ Accordingly the 2006 law included two provisions enabling the reorganisation of struggling companies, reorganisation⁵⁹ and

⁵⁵ Michelle J White, ‘The Corporate Bankruptcy Decision’ (1989) 3 *Journal of Economic Perspectives* 129.

⁵⁶ Reorganisation cases have tended to be concentrated in particular areas, notably the more advanced southeastern coastal cities: Changyin Han, ‘The Practice of Reorganization in China’ (2016) 33 *Arizona Journal of International and Comparative Law* 275, 276 which have greater levels of both existing experience of bankruptcies and economic development. See further Zinian Zhang, *Corporate Reorganisations in China: An Empirical Analysis* (Cambridge University Press 2018) for an empirical study of reorganisation cases as reported in news sources. One surprising factor has been the rate at which reorganisations can lead to apparent company rescues, as opposed to mere business rescues. However this rescue has tended to be illusory, as companies may be saved only in order to retain the benefit of the company’s non-transferrable business license, which a company is issued with upon incorporation and which it requires for trade. In such cases all that is saved is the shell of a listed company, so that its listed status can be retained. This is done by a purchase of the shares of the company and the sale proceeds being used to repay the company’s debts as far as possible: Richard C. Pedone and Henry H. Liu, ‘The Evolution of Chinese Bankruptcy Law: Challenges of a Growing Practice Area’ (Aspatore 2010) <https://www.nixonpeabody.com/-/media/Files/Alerts/China_Bankruptcy_Law_Pedone.ashx>, accessed 17 January 2019. Therefore these cases do not represent examples of company rescue in a true sense of rescue as a going concern.

⁵⁷ Shimin Gao and Qianyu Wang, ‘The US Reorganization Regime in the Chinese Mirror: Legal Transplantation and Obstructed Efficiency.’ (2017) 91(1) *Am Bankr LJ* 139, 140-1.

⁵⁸ J Bradley Johnston, ‘The Bankruptcy Bargain.’ (1991) 65(2) *Am Bankr LJ* 213, 216.

⁵⁹ EBL 2006, Arts 70-94.

composition,⁶⁰ alongside the liquidation laws which are a necessary part of any insolvency system but which have played too dominant a role historically. Reorganisation, along the lines of the US Chapter 11 approach, can potentially preserve value by enabling jobs to be saved, while also bringing potential benefits of ongoing business relationships and higher returns to creditors through the negotiation and approval of a plan of reorganisation.⁶¹

The new law adopted a greatly reformed system of governance, reflecting a reduced role for the state. In insolvency systems, governance structures⁶² tend to involve a blend of controls by insolvency practitioners; the courts; the debtor, under supervision; and creditors. The Chinese law fits in with this pattern but it is notable that its blend is changing in accordance with the transition to a market-based system. State direction was ostensibly stripped away and a new role of administrator was created to oversee cases upon being appointed by the court. The use of a liquidation group remained possible in some instances, however, in particular to resolve labour related issues and to handle the bankruptcies of SOEs.⁶³ Indeed the use of liquidation groups has tended to be common in reorganisation cases,⁶⁴ with only

⁶⁰ EBL 2006, Arts 95-106.

⁶¹ The simpler composition procedure is based on consultation and negotiation with creditors with a view to an agreement for the settlement of unsecured claims against the debtor.

⁶² Charles J Tabb and Alice Curtis Campbell, 'The Importance of Bankruptcy Law to Economic Development and Implications for China' (2006) 22 *Insolvency Law and Practice* 98. These historical divisions are however becoming increasingly blurred and many systems offer a combination of these approaches.

⁶³ Haizheng Zhang, 'A Notable Feature of China's New Bankruptcy Law: "Administrator"' (2009) 6 *International Corporate Rescue* 98.

⁶⁴ Huimiao Zhao, 'Reorganization of Listed Companies with Chinese Characteristics' (2017) *Am Bankr LJ* 87, 121.

12% of reorganisation cases being managed by a wholly private administrator.⁶⁵ The role of administrator was a new one requiring the development of new skills and competencies for law and accountancy firms and it offered the prospect of management of insolvency proceedings in an independent manner in the interests of creditors and free from state control. Other new governance institutions were the creditors' meeting and creditors' committee. The institutions that might be expected under a market-based bankruptcy framework are therefore present but progress is to be made in the development of these institutions in place of state influence.⁶⁶

Factors in the operation of the law

The environmental factors previously described necessarily limited the initial impact of the law and there were other issues that arose as the courts, creditors, directors and others got used to a new governance system, leading to low numbers of cases.⁶⁷ Indeed the number of cases initially decreased compared with the numbers in the years prior to the time when the new law came into force and in the first few years of the law's operation the numbers decreased further and there were few reorganisation cases and even fewer instances of

⁶⁵ Huimiao Zhao, 'Reorganization of Listed Companies with Chinese Characteristics' (2017) *Am Bankr LJ* 87, 124.

⁶⁶ More recently, the establishment and improvement of impartial bankruptcy laws was discussed by President Xi Jinping and United States President Barack Obama at the G20 Summit in Hangzhou: 'Chinese Outcome List of the Meeting Between the Chinese and US Presidents in Hangzhou' *Global Times* (September 4 2016).

⁶⁷ For an early review see Li Shuguang and Wang Zuofa, 'China's Bankruptcy Law after Three Years: The Gaps Between Legislative Expectancy and Practice and the Future Road' (2010) 7 *International Corporate Rescue* 303 and 373.

composition.⁶⁸ This was not to say, however, that there were no failures. Rather there were significant numbers of companies leaving the market without going through the formal, collective bankruptcy procedure, about 7-800,000 each year. If we take bankruptcy as the mandated process for ending the affairs of an insolvent company, in accordance with creditor priorities established under statute, we can see here a deviation from market expectations. The numbers of formal insolvency proceedings may be regarded as low, considering that there are an estimated 77 million businesses in China.⁶⁹ A variety of factors has contributed to this shortfall, and while state influence in part will have impacted on some cases, as discussed below, there are indications that this influence is declining and that market influence is playing a greater role but that progress must still be made in addressing weaknesses that have limited the capacity of institutions to handle the insolvencies which have emerged.

⁶⁸ Composition enables a compromise with creditors to be reached but it does not enable secured creditors to be bound. See EBL 2006, Chapter 9.

⁶⁹ In contrast, in rough numbers, in the UK there were 5.5 million businesses and about 18000 company insolvencies in the year leading to Q3 of 2017. In the US in the year ending June 30 2016, there were about 30 million companies and just over 500,000 corporate insolvencies (509,769 cases brought under Chapter 7 in the US, 300,858 under Chapter 13 and 7,928 under Chapter 11 (with a further 459 under Chapter 12). See <<http://www.uscourts.gov/news/2016/07/27/june-2016-bankruptcy-filings-down-69-percent>> accessed 17 January 2019. Based on rough estimates, there are 77 million business in China and about 5665 formal insolvencies in 2016 (800000 informal); 5.5 million business in the UK and 18000 insolvencies (therefore China has roughly 14 times the number of companies that the UK has but about a third of the insolvencies); 30 million businesses in the USA and around 500,000 insolvencies (less than half the number of companies that there are in China and 100 times the number of insolvencies).

Disincentives for Filing

The conditions for opening proceedings are now, on paper at least, in the hands of debtors and creditors, free of state influence. Article 2, which contains the conditions for opening proceedings, has no loophole enabling a company to be protected where it is a public utility enterprise or an enterprise with an important relationship to the economy and livelihoods, as under the 1986 Law, and it might therefore be expected that the market would influence the opening of proceedings in appropriate cases, free of state influence. Insolvency proceedings can be opened by the debtor or its creditors where the conditions of Article 2 are met. There is however a lack of incentives for either to do so. Creditors may be reluctant to open proceedings,⁷⁰ owing to the prominence given to the treatment of employees, since the courts are required to safeguard the legitimate rights and interests of employees;⁷¹ a debtor is required to submit an employee resettlement plan when filing,⁷² which may impact upon returns to creditors, and employee claims have priority over unsecured claims.⁷³ Company

⁷⁰ In May 2019, the government of Harbin gave a notice on its official website that ten real estate agents were suspected of embezzlement and misappropriation of transaction funds, see http://www.harbin.gov.cn/art/2019/5/31/art_2865_720145.html, accessed 24 June, 2019. These agents clearly lacked the capacity to discharge all their debts but none of their creditors (over 380 persons) applied for bankruptcy process, nor did the debtor. As an example, one of the agents Yitong Real Estate Agent Ltd., was the subject of suits by creditors since 2018 yet none of them applied for its bankruptcy. The case information can be found at <https://www.qixin.com/company-risk/779072da-4a15-4657-a4a5-1737134e7f71>, accessed 24 June 2019. Recently, as one of the creditors of Yitong said, the local government has paid lawyers to bring debt enforcement lawsuits against Yitong for the creditors but the use of the bankruptcy procedure was not considered.

⁷¹ EBL 2006, Art 6.

⁷² EBL 2006, Art 8.

⁷³ EBL 2006, Art 113.

directors may have fears as to the possible consequences of opening proceedings giving rise to liabilities.⁷⁴ There is a further limitation that companies can only file for reorganisation in cases where they are insolvent,⁷⁵ in contrast to other systems which enable filing at an earlier stage⁷⁶ and the requirement of an employee settlement plan is likely to lead to costs and delays to filing. Moreover directors who have given guarantees may be reluctant for the company to enter insolvency proceedings as there is no means for them to obtain a discharge of resulting liabilities through filing for personal insolvency.⁷⁷ Liabilities under mutual guarantees given by related companies are a further source of concern.⁷⁸ These factors have contributed to a low number of cases, as have problems with infrastructure, discussed in the next section.

⁷⁴ EBL 2006, Art 125. See generally in Bin Wang, 'Improper Trading in Bankruptcy and Director Liabilities' in R Parry, Y Xu and H Zhang (eds), *China's New Enterprise Bankruptcy Law* (Ashgate 2009), 271-292.

⁷⁵ EBL 2006, Art 2 enables proceedings to be opened where the debtor is unable to pay its debts as they fall due and its liabilities exceed in value the value of the assets, or where the company obviously lacks liquidity.

⁷⁶ US Code, Title 11, Chapter 11 permits filing regardless of the debtor's state of solvency; the UK IA 1986, Sch B1 permits the opening of administration proceedings in cases where the company is reasonably likely to become insolvent but is not actually solvent yet, whereas the CVA procedure has no insolvency requirement.

⁷⁷ A position that may be changing: 'Personal Bankruptcy: A Way Out' *The Economist*, (June 1 2019).

⁷⁸ Gabriel Wildau, 'In wealthy Chinese city, debt guarantees spark default contagion' *Reuters Business News*, (April 27 2014); Du Wanhua, 'Ten Issues that Must be Grasped in the Current Bankruptcy Trial Work' (4 April 2018, Beijing) *People's Court Daily* <http://rmfyb.chinacourt.org/paper/images/2018-04/04/05/2018040405_pdf.pdf>, accessed 17 January 2019; Shu Zhang, 'Debt guarantee tangle - China's private firms hit by default contagion', *Reuters Stocks News* 12 February 2019; *Bloomberg News*, 'China's Chain of Debt Guarantees Looms as Systemic Danger' *Bloomberg* 18 November 2018..

Development of the infrastructure

A particular problem has been a skills gap,⁷⁹ with courts, administrators⁸⁰ and lawyers having to gain new experience while provided with a generally brief bankruptcy law, a problem not helped by the lack of filings. However, under the 2006 Law the burdens placed on a court that accepts a bankruptcy case are significant, which has impacted on the volume of cases accepted to date. A review of the legislation reveals notable levels of court involvement, not only in relation to matters such as the opening of proceedings⁸¹ and cross-border recognition,⁸² but also in some administrative capacities that in other jurisdictions would not tend to require court involvement. These include the notification of creditors and public announcement of case,⁸³ the convening of the creditors' meeting,⁸⁴ the appointment of the chair of the meeting.⁸⁵ A creditors' committee may be established to exercise some

⁷⁹ INSOL International, *Review of the PRC Bankruptcy Law in 2009*, March 2010, Technical Series Issue 11

⁸⁰ A problem of administrators relying upon the courts for guidance is noted by Richard C. Pedone and Henry H. Liu, 'The Evolution of Chinese Bankruptcy Law: Challenges of a Growing Practice Area' (Aspatore 2010), 3 <https://www.nixonpeabody.com/-/media/Files/Alerts/China_Bankruptcy_Law_Pedone.ashx>, accessed 17 January 2019.

⁸¹ EBL 2006, Arts 10, 11, 12, 71.

⁸² EBL 2006, Art 5.

⁸³ EBL 2006, Art 14.

⁸⁴ EBL 2006, Art 62, 84. For instance, in *Bankruptcy Reorganization Case of Jiangsu Xiake Environmental Protection Colored Textile Co., Ltd.*, the Intermediate People's Court of Wuxi City, Jiangsu Province convened the creditor's meeting and approved the reorganization plan according to Section 2 of Art 84 of the EBL 2006.

See

<http://www.pkulaw.cn/Case/pfnl_a25051f3312b07f3012e0d3a3856550bc2ac39ccdb513227bdfb.html?match=Exact>, accessed 23 June 2019.

⁸⁵ EBL 2006, Art 60.

supervisory functions⁸⁶ and the court is required to give approval of the creditors' committee membership.⁸⁷ The appointment, replacement or approval of resignation of the administrator is also handled by the court.⁸⁸ The courts also are required to approve the conversion of reorganisation proceedings to debtor in possession proceedings.⁸⁹ The courts are required to give approval to reorganisation plans⁹⁰ composition plans⁹¹ and distribution plans in

⁸⁶ EBL 2006, Art 68.

⁸⁷ EBL 2006, Art 67.

⁸⁸ EBL 2006, Art 13, 22, 29. See e.g. *Qingtian Shengtong Valve Foundry Co. Ltd v Yongjia Guanhao Valve Manufacturing Co. Ltd* Available at http://www.pkulaw.cn/Case/pfnl_a25051f3312b07f36f547761d1df0de9cbc19bcb9a0c746bbdfb.html?match=Exact , accessed 23 June 2019.

⁸⁹ EBL 2006, Art 73. The example of Shenzhen Zhonghua Bicycle is given as an example of such a case in the Supreme People's Court, 'Ten Model Cases regarding Trial of Bankruptcy Cases according to the Law and Promotion of the Supply-Side Structural Reform' (15 June 2016) <<http://en.pkulaw.cn/display.aspx?cgid=a25051f3312b07f3e4c2d73206a7d1564df0ee829d4e892bbdfb&lib=case>>, accessed 9 June 2019.

⁹⁰ EBL 2006, Art 86. See e.g. *Bankruptcy Reorganization Case of Kunming Jurenxing Rubber Co., Ltd*, available at http://www.pkulaw.cn/Case/pfnl_a25051f3312b07f339307963d0484877652292b4c04744d0bdfb.html?match=Exact, accessed 23 June 2019.

⁹¹ EBL 2006, Art 98.

liquidation. The courts also have cramdown powers along similar lines to the United States model.⁹² As might be expected, the court also decides if proceedings are to be terminated.⁹³

The heavy involvement of courts in cases, combined with the limited number of previous bankruptcy cases and relative concentration of those cases in particular geographical areas meant that many courts were unfamiliar with bankruptcy cases and placed limitations on the acceptances of cases, so that numbers of cases remained low. The courts already had significant workloads and the acceptance of a bankruptcy case would have entailed judges having to gain familiarity with a new and technical branch of law, which also comes with a significant associated workload,⁹⁴ in the absence of detailed guidance. There was therefore a reluctance of local courts to accept bankruptcy cases, which are complex and time consuming.

Given these pressures and practical limitations some courts issued restrictions on the cases that they would accept, suspending applications or accepting only those with state support. For example, in 2002, the third civil court of Xuzhou⁹⁵ Municipal Intermediate People's Court reported that the Municipal Court issued a temporary restriction, declining all

⁹² EBL 2006, Art 65, 87. See Yujia Jiang, 'The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of U.S. and Chinese Bankruptcy Law' (2013-14) 34 Nw. J. Int'l L. & Bus. 559, 577-8 for a comparison with US law and judicial practices.

⁹³ There are various grounds upon which proceedings can be terminated. A case may be terminated in the event of insufficient assets being available to pay costs (Art 43); Termination of reorganisation proceedings by the court (Art 78, 88, 93); termination of composition proceedings by the court (Art 99, 104); termination of liquidation where debts can be repaid (Art 108); termination of liquidation where no funds available for distribution (Art 120).

⁹⁴ Rebecca Parry and Haizheng Zhang, 'China's New Bankruptcy Law: Notable Features and Key Enforcement Issues' in Paul Omar (ed), *International Insolvency Law: Themes and Perspectives* (Routledge 2008).

⁹⁵ Xuzhou is a major city in the east of the PRC, known as a transportation hub.

applications for insolvency made by creditors, or made without approval from the local authorities.⁹⁶ High levels of state control over the opening of proceedings were therefore present under this approach. More recently, matters have been improved by the issuing of a *Notice of the Supreme People's Court on the Relevant Issues of Accepting Bankruptcy Cases*, issued on July 28, 2016, which clarified many points in relation to the law in relation to the filing and opening of cases and case administration. Nonetheless, it is expected that the impact of this additional guidance will vary regionally⁹⁷ with experienced courts in Zhejiang, Shandong and Shenzhen taking a leading role. In addition, a positive development has been the establishment of three specialist bankruptcy courts in Beijing, Shanghai and Shenzhen in 2019 based on the former liquidation and bankruptcy courts which were set up since 2016 nationwide. In another important initiative a website, the National Bankrupt Enterprise Reorganisation Cases Information Internet, has been launched to better facilitate case management, including the submission of claims by creditors as well as their attendance at meetings.⁹⁸ The building of this improved infrastructure should enable the opening of a greater number of cases to be supported.

A result of these restrictions by the courts has been that cases are often handled under the individual debt enforcement processes, rather than the collective insolvency procedures. As a

⁹⁶ Yingmao Tang, 'Why Do Judgment Enforcement Organizations Resolve Bankruptcy Disputes in China?' (2008) 45 *Journal of Peking University (Humanities and Social Sciences)* 12, 17.

⁹⁷ Minny Siu and others, 'The Filing Registration System for Chinese Court Accepting Bankruptcy Filing - Latest Trends and Revelations for Automatic Early Termination in Off-the-Shelf Financial Derivatives Transactions' (King & Wood Mallesons, 2016) <<http://www.kwm.com/zh/hk/knowledge/insights/the-prc-court-registration-system-for-bankruptcy-petitions-latest-developments-20161118>> accessed 17 January 2019.

⁹⁸ Discussed further in Stacey Steele et al, 'Trends and Developments in Chinese Insolvency Law: the First Decade of the PRC Enterprise Bankruptcy Law' (2018) 66 *The American Journal of Comparative Law* 669.

result, many distressed debtors are sued even though they lack the capability to pay,⁹⁹ while the debt enforcement processes rarely lead to a fair distribution of the debtor's assets.¹⁰⁰ Situations of financial distress preferably require a collective response, however, and efforts are now being made in some areas to filter such cases towards the bankruptcy processes. For example, from 2015 to 2017, the courts in Quzhou¹⁰¹ had accepted 128 bankruptcy cases, and 58 of them were transferred from the enforcement process.¹⁰² In January 2017, the Supreme People's Court issued the "*Guiding Opinions on Several Issues Concerning the Transfer of Enforcement Cases to Bankruptcy Examination*" (the Opinions) to smooth the transfer of cases from enforcement process to bankruptcy process. The aim of the Opinions is to improve both the enforcement process by splitting the distressed debtors from other debtors but also to enhance the acceptance of formal bankruptcy cases. However, the implementation of the approach set out in the Opinions presents difficulties in practice from both the debt enforcement sector and the bankruptcy sector. The 2018 Summary considers how transfers might be made more smoothly. However, the Summary merely underlines the approach taken in the Opinions and a practical impact has yet to be achieved. The difficulty lies in the working habits of different sectors of the courts which can give rise to tensions, whereby the officers of the execution sector are unwilling to transfer their own tasks to others and the

⁹⁹Yingmao Tang, 'Why Do Judgment Enforcement Organizations Resolve Bankruptcy Disputes in China?' (2008) 45 Journal of Peking University (Humanities and Social Sciences) 12, 17.

¹⁰⁰ Zinian Zhang, 'The Corporate Bankruptcy Substitute in China' presented at the Law, Finance and Development with Chinese Characteristics conference, jointly organised by University of Leeds School of Law at SOAS, 25 June 2019.

¹⁰¹ A major city of Zhejiang Province in the southeastern China.

¹⁰² Kaihua People's Court, 'Risk Analysis and Prevention of Enterprise Mutual Insurance under the Background of 'Enforcement to Bankruptcy' (7 September 2017) <<http://www.khcourt.gov.cn/news/2017/08/237279.html>>, accessed 17 January 2019.

bankruptcy sector officers may consider that such a transfer is forcing them to finish the job of the other.

Effective handling of such cases requires improvements to the infrastructure to support bankruptcies and to this end bankruptcy divisions of intermediate courts are being established. Much has been accomplished in this regard already and, by April 2018, 97 specialist liquidation and bankruptcy courts have been established all over China.¹⁰³

Specialist divisions are likely to be of significant benefit given the, as yet, skeletal nature of the bankruptcy legislation and the range of tasks that the courts are required to perform in a bankruptcy case. The development of specialist expertise can help to address the gaps and it can be expected that the establishment of specialist courts will be continued, alongside the training of sufficient numbers of judges that have relevant expertise and enough time to work on the bankruptcy trial work. Continued progress in this regard can also be expected to lead to greater levels of acceptances of bankruptcy cases, as the reluctance previously noted should ease. Of course, the provision of a judicial framework is insufficient in itself and efforts are still needed to incentivise the debtors and creditors to bring a bankruptcy application before the courts upon the emergence of financial distress.

Administrator System

The effectiveness of the bankruptcy system will depend not only on the establishment of specialist courts and creativity in relation to processes, it will also require the development of experienced and expert administrators to replace the state-centred liquidation groups as the controllers of insolvency proceedings. The office of administrator is an important role in the

¹⁰³ Du Wanhua, 'Ten Issues that Must be Grasped in the Current Bankruptcy Trial Work' (4 April 2018, Beijing) People's Court Daily <http://rmfyb.chinacourt.org/paper/images/2018-04/04/05/2018040405_pdf.pdf>, accessed 17 January 2019.

insolvency process,¹⁰⁴ and can be regarded as one of the key features of a collective, market-based system.¹⁰⁵ The office of administrator therefore is highly important if state influence is to be reduced, however this office has yet to reach its full potential.

There are several suggestions in the Summary for the improvement of the administrators' system. Firstly, the types of persons and firms permitted to act as administrators should be broadened and the potential sources of administrators in individual cases expanded. For example, the idea is entertained that turnaround in specialist areas can more effectively be achieved by industry specialists. Even if such persons do not possess expertise in relation to all aspects of the work of administrators they could be appointed as advisers in particular cases. In addition, the geographical limitation of the list could potentially be removed.¹⁰⁶ Secondly, it is advisable that an administrators association should be established to regulate the management of administrators.¹⁰⁷ Presently, the People's Court is the only body who can punish the administrator when she/he fails to act with due diligence and faithfully perform her/his duties,¹⁰⁸ yet it is normally difficult for a creditor, debtor or a third party to prove such

¹⁰⁴ Haizheng Zhang, 'A Notable Feature of China's New Bankruptcy Law: "Administrator"' (2009) 6 International Corporate Rescue 98.

¹⁰⁵ The market-based nature of the restructuring of CSC Phoenix Co Ltd is emphasised in the first example in Supreme People's Court, 'Ten Model Cases regarding Trial of Bankruptcy Cases according to the Law and Promotion of the Supply-Side Structural Reform' (15 June 2016) <<http://en.pkulaw.cn/display.aspx?cgid=a25051f3312b07f3e4c2d73206a7d1564df0ee829d4e892bbdf&lib=case>>, accessed 9 June 2019.

¹⁰⁶ Currently, the administrators lists are managed or supervised by the higher courts or intermediate courts, the potential administrators on the list are limited to the higher courts or intermediate courts' jurisdiction.

¹⁰⁷ By March 2019 and since 2014, 23 local administrator associations had been established national wide. However, the functions of those local administrator associations vary.

¹⁰⁸ EBL2006, Art 130.

failure. For example, in *Wang Junjie v Beijing Tianzheng Law Firm*,¹⁰⁹ the court held that the creditor (Wang Junjie) had no legal right to ask the administrator (Beijing Tianzheng Law Firm) for any particular performance. Further, as the administrator had provided evidence of its performance, it was difficult for Wang Junjie to prove that the administrator had failed to meet the due diligence requirement. To improve levels of creditor protection, it may be helpful to have an association work both as a regulator and facilitator of such cases. Thirdly, even where the administrator has been appointed by the court, it is arguable that the appointing process should fully introduce a competitive mechanism, and effectively select the administrator from a wider range of candidates to improve the quality of bankruptcy management. Further, a bankruptcy administrator's salary guarantee system is suggested to solve the problem of insufficient remuneration of administrators in bankruptcy cases, which may act as a disincentive for skilled individuals to pursue this line of work.

Remaining State Influence

Although the control of the state has ostensibly been stripped away in favour of administrator control and the removal of the power to block the opening of proceedings it is notable that state influence can still be exerted at various levels.¹¹⁰ This is most evidently so in cases where the liquidation group has been preserved but it has also been evident in the pervasive

¹⁰⁹ Available at

http://www.pkulaw.cn/Case/pfnl_a25051f3312b07f395f0114e9b568186708c5dcdd0075b0cbdfb.html?match=Exact> accessed 20 June 2019.

¹¹⁰ State control in high-level cases can be exerted in relation to bankruptcies of listed companies, which require the approval of either the China Securities and Regulatory Commission or, in some instances, the Supreme Court. In a case where there is some state involvement in a company, whether as sole owner, partial owner or even as a minority shareholder, the SASAC will take part in the bankruptcy

role of the courts. In particular in the early years of the law's operation the role of the courts in bankruptcy proceedings enabled local government to intervene by the back door, to direct the case in the interests of maintaining social stability, upon which the local government's performance is judged,¹¹¹ in particular through the preservation of employment.¹¹² The courts are institutionally and financially dependent on local governments¹¹³ which have accordingly been able to influence the courts,¹¹⁴ and which have facilitated the bankruptcy proceedings, initially through the formation of a task force, which is then appointed as the liquidation group in place of an administrator.¹¹⁵

More recently, influence appears to be changing¹¹⁶ in some cities in line with government efforts to implement the Supply-Side Structural Reform policy of reducing excess industrial

¹¹¹ Wang Zuofa, 'The Political Economy of the Implementation of the Bankruptcy Law of China' (2015) 6 *Asian Journal of Law and Economics* 249.

¹¹² The prominence given to employee interests in the EBL 2006 was noted above.

¹¹³ The case will be heard by the court where the debtor is domiciled and there is no scope for forum shopping: EBL 2006, Art 3.

¹¹⁴ Qianfan Zhang, 'Judicial Reform In China: An Overview' John Garrick and Yan Chang Bennett (eds), *China's Socialist Rule of Law Reforms Under Xi Jinping* (Routledge 2016), 19.

¹¹⁵ Wang Zuofa, 'The Political Economy of the Implementation of the Bankruptcy Law of China' (2015) 6 *Asian Journal of Law and Economics* 249, 272, n 60. Zhao Huimiao, 'Lame-Duck Bankruptcy Institutions under Government Intervention in Reorganisation of Listed Companies in China' (Part 2) (2016) HKLJ 709-743 found that the liquidation group was the dominant type of administrator in a sample of 45 reorganisation cases involving listed companies.

¹¹⁶ An impression given by the discussion of the CSC Phoenix Co Ltd case in Supreme People's Court, 'Ten Model Cases regarding Trial of Bankruptcy Cases according to the Law and Promotion of the Supply-Side Structural Reform' (15 June 2016)

<<http://en.pkulaw.cn/display.aspx?cgid=a25051f3312b07f3e4c2d73206a7d1564df0ee829d4e892bbdfb&lib=cas>>, accessed 9 June 2019

capacity, announced by President Xi Jinping in 2015. It is notable that there has been a strong increase in the numbers of cases from 2016 onwards.¹¹⁷ There has been a stepping-up of efforts to reorganise uneconomic SOEs, to enable more effective deployment of their assets, and consequently some zombie companies have been eliminated from the market, including in the landmark failed restructuring of Guangxi Nonferrous Metal Group, the first significant SOE to be placed into involuntary liquidation post-2006.¹¹⁸ Before 2016, in most cases, even the liquidation cases would preserve the business as a whole,¹¹⁹ such as in the bankruptcy of Zhejiang Glass Co. Ltd and its affiliated companies.¹²⁰

¹¹⁷ Lu Mingkang and Chuyi Wei, 'Towards a Better Future for Chinese Bankruptcy Law: Problems and Potential' (2017) 28 ICCLR 443-452.

¹¹⁸ Notably this company had diversified borrowings, with capital gained from the bond market, rather than borrowed from state banks, which left the company vulnerable. See further Dinny McMahon, 'The Anatomy of a Bankrupt State Firm's Liquidation' (*Marco Polo* 26 September 2017) <<https://macropolo.org/anatomy-bankrupt-state-firms-liquidation/>> (accessed 17 January 2019) regarding the background to this case.

¹¹⁹ Arnab Bhattachargee and Jie Han, 'Financial Distress of Chinese Firms: Microeconomic, Macroeconomic and Institutional Influences' (2014) 30 *China Economic Review* 244, 245.

¹²⁰ The Supreme People's Court, 'Ten Model Cases regarding Trial of Bankruptcy Cases according to the Law and Promotion of the Supply-Side Structural Reform' (15 June 2016)<<http://en.pkulaw.cn/display.aspx?cgid=a25051f3312b07f3e4c2d73206a7d1564df0ee829d4e892bbdfb&lib=case>>, accessed 9 June 2019. In the Zhejiang Glass case, on 28 June 2012, the Intermediate People's Court of Shaoxing City (the Court) opened the procedure for bankruptcy reorganization according to the application of the creditors. On 4 July 2012, the administrator applied for the merger and reorganization of Zhejiang Glass and its four affiliated companies on the grounds that there was personality confusion between Zhejiang Glass and its four affiliated companies. Accordingly, the Court approved the application after a hearing of most of the creditor representatives, Zhejiang Glass and its affiliated companies. However, the ordinary creditor group did not pass the reorganization plan initiative, which led to the failure of the reorganization plan initiative to be adopted by the creditors' meeting. On 25 March 2013, the Court decided to terminate the reorganization

These developments can be regarded as evidence of a less interventionist approach and a more liberal approach in some instances to bankruptcies as a means of resolution of corporate debt problems¹²¹ in place of bailouts.¹²² Another example is the wave of insolvencies in Shandong province in late 2018 and early 2019 arising from factors such as overcapacity in the tyre industry¹²³ and the calling in of mutual guarantees.¹²⁴ State influence has also been changing and it has been noted that in some cities, the efforts of local governments have been more concerned with facilitating the restructuring through persuading creditors and arranging favourable tax treatment.¹²⁵ However the position remains complex and subject to factors such as political connection¹²⁶ and social impact so that state persuasion may be influential

procedure and transfer it to the liquidation procedure in accordance with the provisions of Article 88 of the EBL 2006. In order to minimise the devaluation of the assets and avoid a substantial increase in maintenance costs of shutting down the production line, the administrator entrusted a third party to maintain the normal production and operation. Finally, the businesses were sold through public auction and sale as a working business.

Therefore, most of the employees were able to maintain their jobs and income during the bankruptcy process.

¹²¹ Li-Wen Lin, Curtis J. Milhaupt, 'Bonded to the State: A Network Perspective on China's Corporate Debt Market', (2017) 3(1) *Journal of Financial Regulation* 1, 30,

¹²² Naomi Moore, F Mark Fucci and Jingli Jiang, 'China' in *The Asia-Pacific Restructuring Review 2018* <www.globalrestructuringreview.com>, accessed 28 June 2019.

¹²³ Sunny Chao, 'China's 10th-Largest Tire Company Goes Bankrupt, Pressured by US-China Trade War' *Epoch Times* 23 August 2018.

¹²⁴ 'Bankruptcy Run in Wealthy China Province Spooks Creditors', *Macau Daily Times* 5 April 2019, notes that the local government has not been consistent in its approach, however.

¹²⁵ Stacey Steele et al, 'Trends and Developments in Chinese Insolvency Law: the First Decade of the PRC Enterprise Bankruptcy Law' (2018) 66 *The American Journal of Comparative Law* 669.

¹²⁶ Yu He, Lei Xu and Ron P McIver, 'How Does Political Connection Affect Firm Financial Distress and Resolution in China' (2019) 51 *Applied Economics* 2770.

behind the scenes in supporting restructuring of SOEs in other cases in years to come.¹²⁷

Even in market-based systems there remains a role for the state in cases of potentially high social costs, on account of systemic risk or social importance.

In remaining cases where the government is involved in an insolvency the Summary identified that it would be of benefit to a “bankruptcy unified coordination mechanism” in which the government and the courts can work together smoothly. The government is expected to support the courts with tax incentives, credit repair, and facilitating the resettlement and protection of employees in bankruptcy. Bankruptcy cases that may trigger financial risks and affect social stability will be evaluated according to law, plans will be formulated, and progress will be made steadily. Particular care may need to be taken in relation to enterprises that have mutual guarantees, serial guarantees,¹²⁸ private financing or illegal fund-raising relationships, as, without effective measures, there could be a triggering of regional risks and mass incidents.

There has been a development of special approaches for the protection of high-quality enterprises, especially high-tech enterprises, that are experiencing temporary distress caused

¹²⁷ Huimiao Zhao, ‘Reorganization of Listed Companies with Chinese Characteristics’ (2017) *Am Bankr LJ* 87, 120. On the state’s role in corporate governance more generally see Andrew Keay & Jingcheng Zhao, ‘Transforming Corporate Governance in Chinese Corporations: A Journey Not A Destination’ (2018) 38 *Northwestern Journal of International Law and Business* 187.

¹²⁸ According to Kaihua people’s court, 81% of the enforcement cases leading to bankruptcies in Quzhou municipality between 2015 and 2017 were related to mutual insurance and mutual guarantees. Kaihua People’s Court, ‘Risk Analysis and Prevention of Enterprise Mutual Insurance under the Background of ‘Enforcement to Bankruptcy’ (7 September 2017) <<http://www.khcourt.gov.cn/news/2017/08/237279.html>>, accessed 17 January 2019.

by shocks such as the Sino-US trade wars. These measures aim to preserve value by enabling a business to maintain its high quality overall production management system and capabilities, rather than using a value-destroying auction break-up sale approach to clear the company's liabilities, leading to the destruction of its overall production management system and capabilities.

An approach to development of turnaround expertise can be illustrated by the bankruptcy reorganisation of Chongqing Iron and Steel Co. Ltd. This company entered reorganisation proceedings in July 2017 when a liquidation group was appointed. The successful bankruptcy reform of this company came about because of the introduction of the "Four Sources Fund". The "Four Sources Fund" is essentially a rescue enterprise established for the restructuring of the steel industry and with mastery of the different production factors of steel production, including capital, the steel industry market, steel industry management, steel industry technology and other production factors. These new production factors were used to improve the processes and procedures of Chongqing Iron and Steel Co., Ltd and a turnaround was consequently achieved in the short months after the reorganisation.¹²⁹ In October 2018 the company announced a net profit of 1.48 billion yuan had been achieved in the 9 months from January to September, compared with a net loss of 882.08 million yuan a year earlier.¹³⁰

Naturally the interests of the state will not always align with the interests of creditors. There have been concerns in some cases that bankruptcy proceedings have been used for the

¹²⁹ Du Wanhua, 'Ten Issues that Must be Grasped in the Current Bankruptcy Trial Work' (4 April 2018, Beijing) People's Court Daily <http://rmfyb.chinacourt.org/paper/images/2018-04/04/05/2018040405_pdf.pdf>, accessed 17 January 2019.

¹³⁰ 'Chongqing Iron & Steel Returns to Black In Jan-Sept With Net Profit Of 1.48 Bln Yuan' (Reuters, 29 October 2018) <<https://www.reuters.com/finance/stocks/1053.HK/key-developments/article/3924531>>, accessed 17 January 2019.

disenfranchisement of bond holders and that restructuring can potentially be used to cheaply transfer business assets to state ownership while leaving creditors with claims that are not fully met.¹³¹ In other cases the state has been behaving as an uncooperative creditor, as companies often have property leased from the government, yet such claims are only unsecured in status,¹³² and this may have a limiting effect on reorganisation prospects.

The numbers of bankruptcy cases are likely to continue to grow. One factor is that it has become easier to establish companies in China following an easing of the capital requirements.¹³³ Given the high failure rates of startups, we might expect the numbers of private company bankruptcies to increase and the building of the infrastructure to support these cases must continue apace. There is also likely to be a growth in personal insolvencies, both through increased consumer debt and also through calling-in of guarantees given by

¹³¹ Ren Hulian and Leng Chen, 'Shandong Industrial Debt Crisis Claims Two More Companies' Caixin (March 18 2019).

¹³² Naomi Moore, F Mark Fucci and Jingli Jiang, 'China' in *The Asia-Pacific Restructuring Review 2018* <www.globalrestructuringreview.com>, accessed 28 June 2019, noting also similar issues in respect of tax claims and claims from municipal utility providers.

¹³³ Decision on Amending the Company Law of the People's Republic of China, promulgated by the Standing Committee of the National People's Congress of the People's Republic of China on December 28th 2013.

owners of failed businesses, and cross-border insolvencies¹³⁴ and it is desirable that the law and legal system should develop to support these cases.¹³⁵

Conclusion

The PRC Enterprise Bankruptcy Law 2006 remains a remarkable achievement but the enactment of formal rules with features of a market-based system was never going to be sufficient in itself to bring about a transformation to a market-based system in practice. This is a transformation which is likely to be gradual and numbers of cases of formal insolvencies have been low, although this limited impact of the 2006 law can be attributed largely to a lack of institutional capacity, combined with limited incentives for creditors and debtors to open the proceedings, alongside the local government influence which has previously been significant. However institutions and political objectives are changing and more recently significant progress towards a market-based system has been made. The Supply-Side Reforms towards the elimination of excess industrial capacity have prompted greater usage of the formal insolvency laws as a means of resolving debt problems. The courts are adapting to build expertise and capacity to handle cases and it can be anticipated that there will be progress in future in the development of the office of administrator. However the legal framework also remains under-developed and further judicial guidance is needed if cases are to be handled in a predictable and consistent way. As to the future, state influence is likely to

¹³⁴ ‘The Several Opinions of the Supreme People’s Court Concerning Judicial Services and Safeguards Provided by the People’s Courts for the ‘Belt and Road’ Construction’ emphasise the importance of a legal infrastructure to support the initiative. See Bingdao Wang, “‘One Belt, One Road’: Promoting Cross-Border Insolvency Cooperation in China’ (Winter 2017/18) 70 *Eurofenix* 22.

¹³⁵ Personal insolvency laws are likely to be introduced initially within small regional areas. ‘Personal Bankruptcy: A Way Out’ *The Economist*, (June 1 2019) briefly reports on a discharge by a court in Taizhou of debts owed by an entrepreneur.

remain in cases where there is a prospect of social instability however such influence is found also in other jurisdictions in cases where an insolvency would have significant negative externalities and it is arguably not inconsistent with the existence of a market-based approach.