

Eliminating Zombie Companies through Insolvency Law in China: Striking a Balance between Market-oriented Policies and Government Intervention

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1. Introduction

Zombie companies are a notable phenomenon in many countries, with inefficient businesses often staying in the market due to low interest rates protecting them from the market forces that might otherwise lead to their demise. These companies merely survive rather than develop and tie up resources that could more productively be employed through Schumpeterian ‘creative destruction’¹. This is an enduring problem in China, where the years of a planned economy and an administrative approach to corporate governance have left a legacy of zombie companies whose presence harms economic development and the functioning of a competitive market. In recent months new fears have emerged that state aids provided to mitigate the devastating impacts of Covid-19 on markets will further enable inefficient enterprises to live artificially prolonged lives as zombie companies. Their existence is impeding the economic transformation in China and the problem has become bigger, posing a threat to the sustainable recovery of the economy.²

Zombie companies, termed *Jiangshi qiye* (殭屍企業), have tended to be particularly well protected from market forces because of bank loans and government backing. State-sponsored zombies have been a more familiar feature of the Chinese market. It has been estimated that in 2005, a time characterised by more state involvement in the market compared to it is now, as many as 20% of state-owned enterprises (SOEs) were zombie companies.³ Government strategies in subsequent years have reduced

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¹ Schumpeterian’s “gale of creative destruction”, when used in cases of firm exits, commonly refers to the displacement of non-innovators being one of the main drivers of exit. J.A. Schumpeter, *The Theory of Economic Development: An Inquiry into Profits, Capital, Credit, Interest, and the Business Cycle*, translated from German by Redvers Opie, (2008, Transaction Publishers: New Brunswick); E. Cefis, F. Malerba, Orietta Marsili & L. Orsenigo, ‘Time to Exit: “Revolving Door Effect” or “Schumpeterian Gale of Creative Destruction”?’ (2020) *Journal of Evolutionary Economics*, <https://doi.org/10.1007/s00191-020-00701-8>.

² T. Huang, ‘As China Recovers from The Pandemic, Will Zombie Firms Return?’ 21st October, 2020, <https://www.piie.com/blogs/china-economic-watch/china-recovers-pandemic-will-zombie-firms-return>

³ Y. Tan, Y. Huang, and W.T. Woo, “Zombie Firms and the Crowding-Out of Private Investment in China,” (2016) 15 *Asian Economic Papers* 32, 39.

this number but zombie companies remain a problem in many areas, yet the optimal approach to dispose of them remains a debated topic. Zombie companies will drag down economic growth and undermine the innovation and competitiveness of healthy companies. The seemingly most effective market-oriented approach for a managed exit of zombie companies is to use insolvency procedures, considering the large quantity of unsophisticated corporate debtors and lack of other formal workout avenues to deal with zombie companies in China.⁴ Meanwhile, the Chinese government, aware of the socially important role that many of these zombie companies play, has tended to prefer more guarded approaches, typified by administrative approaches such as the revocation of business licenses, to handle the affairs of these companies.

A balance must thus be achieved between two forces when dealing with zombie companies: these are the market-oriented measures, necessitated by China's transformation to a socialist market economy and the demands of its external relations, and the administrative approaches, necessitated by the social importance of many zombie companies. Considerable progress had already been made prior to Covid-19's outbreak and China's efforts towards the elimination of zombie companies must be acknowledged. It has been emphasised by authorities and empiricists that the effective removal of zombie companies will require the transformation of the conventional administrative model to an economic model.⁵ Although elements of administrative approaches to zombie companies remain evident in some instances, it is notable that examples of market-based approaches, including the use of insolvency procedures, are becoming increasingly accepted and have grown in usage in China. However, this transition is by no means likely to be a smooth one, since the legal and economic institutions that are necessary to support a market-based approach to insolvency remain under development. It is also undoubtedly the case that state intervention in socially important cases is by no means a uniquely Chinese approach, as illustrated most markedly by the range of temporary state aids provided to companies during the Covid-19 pandemic, and also previously to strategically prop up important financial, and occasionally socially important non-financial, enterprises. It is therefore naive to think that state interference should be eradicated in China. It is also envisaged that both administrative and market-oriented approaches will co-exist in China for a long time to come. However increased use of market-based approach is desirable, both from an internal Chinese perspective of consolidating a productive economy and also due to the demands of China's external relations. The question is how to confront the challenges that this presents through a hybrid of market-led and administrative planned approaches.

⁴ S. Steele, A. Godwin, J. Chun, H. Changyin and R. Yimin, 'Trends and Developments in Chinese Insolvency Law: The First Decade of the PRC Enterprise Bankruptcy Law' (2018) 66 *American Journal of Comparative Law* 669, 671.

⁵ Q. Chang *et al*, 'How Does Government Intervention Affect the Formation of Zombie Firms?' (2021) 94 *Economic Modelling* 768; A. Keay and J. Zhao, 'Transforming Corporate Governance in Chinese Corporations: A Journey Not A Destination' (2018) 38 *Northwestern Journal of International Law and Business* 187.

This article aims to identify the complications brought by the emergence and existence of zombie companies in China, and to evaluate the changing institutional environment to facilitate a more enabling insolvency law scheme to deal with these difficulties in the context of market economy with Chinese characteristics, as well as making some follow-up reform suggestions in order to establish more efficient insolvency regimes and strike a balance between market-oriented policies and government intervention.

The article is structured as follows. Section 2 offers a comprehensive overview of the definition, criteria and characteristics of zombie companies. Section 3 examines in more detail at the socio-economic complications brought by zombie companies. Section 4 reviews the government policies on eliminating zombie companies in China. Section 5 discusses the functions and development of insolvency law in China and the extent to which these may be orientated towards market-based approaches in handling the exits of zombie companies, followed by an analysis of some encouraging experiences and potential proposals for an enhanced insolvency law regime that to be introduced and enacted nationwide. The last section offers some conclusions.

2. Zombie Company: Definition, Method and Characteristics

The concept of the undead is not a new one in China. Its ancestry can at least be traced to the *Qing* dynasty, appearing in traditional Chinese culture in the form of “hopping” vampires, or “rigid corpses”. However, the term “zombie company” is an import. The term was initially coined in relation to insolvent savings and loan corporations in the United States in the 1980s,⁶ and it grew in popular usage after the collapse of the Japanese asset price bubble in late 1991.⁷ At that time the number of zombie companies fast escalated due to the banking sectors continuing to support companies in financial difficulties instead of initiating insolvency procedures, and the prevalence of zombie companies has further led to a period of economic stagnation in Japan from 1991 to 2010, termed the “Lost Decades”.⁸ Additional to its popularity in Japan and Japanese studies,⁹ the term reappeared in the US during the

⁶ The term is credited to Edward Kane by Frank H Easterbrook in, ‘Regulation and Responsibility: A Note on Banking’ (1991-1992) 77 *Cornell L Rev* 1079, 1083. See E. J. Kane, ‘Dangers of Capital Forebearance: the Case of the FSLIC and “Zombie” S&Ls’ (1987) 5 *Contemporary Economic Policy* 77.

⁷ E.g. H. McRae, ‘Korean crisis? We’ve been here before’ *The Independent* 14 Dec, 1997; C. Chandler, ‘In Japan, A Reversal on Reform?: Premier Draws Fire for ‘Go Slow’ Stance on Economy’ (1999) *Washington Post* 29 Oct, 1999; J. Brooke, ‘They’re Alive! They’re Alive! Not!; Japan Hesitates to Put an End to Its ‘Zombie’ Businesses’ *New York Times*, 29 Oct, 2002. Also recently C. Taylor, ‘Why “Zombie” Companies Are on the Rise – and Could Pose a Threat to the US Economy’ *Fortune* 2 Sep, 2019.

⁷ Y. Goto and S. Wilbur, ‘Unfinished Business: Zombie Firms among SME in Japan’s Lost Decades’ (2019) 49 *Japan and the World Economy* 105.

⁸ *Ibid*, at 105.

⁹ S. Fukuda and J. Nakamura, ‘Why Did ‘Zombie’ Firms Recover in Japan?’ (2011) 34 *The World Economy* 1124.

global financial crisis of 2008¹⁰ when some companies were bailed out by the Trouble Asset Relief Programme.¹¹ Still more recently, the Covid-19 pandemic and government support measures have led to concerns of a new wave of zombie companies.¹²

More recently, the concept of zombie companies has gained increasing attention from Chinese academics, government officials, policy makers and practitioners. Many Chinese zombie companies emerged as a result of policies developed in response to the financial crisis of 2008.¹³ At that time the Chinese government instigated expansionary economic policies, as neutral inflationary and monetary policies, with the purpose of invigorating deteriorating industries. The focus of state policies had shifted from domestic demand to international demand. This shift led to unhealthy over-production in certain industries from both the State and local governments, which led to over-capacity and inefficiencies.¹⁴ The lives of some SOEs, which had suffered financial difficulties and become economically inviable, were artificially prolonged in view of their social importance, enabling them to limp on as the “walking dead”. The willingness of the State to support these companies, which although socially important, has been economically unhealthy, and it may have a long-term detrimental impact on the sustainable development of Chinese economic growth and its financial system.¹⁵ Latterly, the Covid-19 pandemic has also stifled growth and it may yet act as a catalyst for further market-based reforms.¹⁶ The elimination of zombie companies had become necessitated as the result of internal pressures which has nullified some protections against market forces, and external pressures, notably tensions in external relations.¹⁷

Looking at the concept in more technical details, zombie companies have been defined in many ways by scholars from different disciplines, according to their

¹⁰ R. Banerjee and B. Hofmann, ‘The Rise of Zombie Firms: Causes and Consequences’ [2018] *BIS Quarterly Review* 67.

¹¹ See <https://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx>

¹² See e.g. K. Schmedders, J. Park and R. Earle, ‘Attack of zombie companies: don't let them eat bailouts that are vital to restore the economy’ *The Conversation* 2 June 2020; D.J. Lynch, ‘Here’s one more economic problem the government’s response to the virus has unleashed: Zombie firms’ *The Washington Post* 23 June 2020; C. Jones, ‘European Zombification becomes even scarier’ *Financial Times* December 3 2020.

¹³ D. Xueliang, ‘Watch Out for the Chronic Illness of the China Model’ (‘警惕中國模式的‘慢性病’), *Nanfang Zhoumo*, 31, 9 December 2011.

¹⁴ Nicholas R. Lardy and Arvind Subramanian, *Sustaining China's Economic Growth After the Global Financial Crisis* (Peterson Institute, 2011), Ch 1.

¹⁵ D. McMahon, ‘China’s Zombie Firms Can’t Lurch Forever: As state-backed Companies’ Debts Mount, China Faces an Inevitable Slowdown’ <https://foreignpolicy.com/2018/03/14/chinas-zombie-firms-cant-lurch-forever/>.

¹⁶ United Nations Development Programme in China, *Assessment Report on Impact of COVID-19 Pandemic on Chinese Enterprises*, https://www.cn.undp.org/content/dam/china/docs/Publications/EN_Assessment%20Report%20Impact%20of%20COVID-19%20Pandemic%20on%20Chinese%20Enterprises.pdf.

¹⁷ N. Martin, ‘Frayed Nerves as China Kills Off its Zombie Companies’, 21 March 2019 <https://www.dw.com/en/frayed-nerve-as-china-kills-off-its-zombie-companies/a-48013707>.

diverse perspectives and characteristics. Focusing on the fact of being subsidised, Stanway and Tham define them as loss-making companies that continue to and will only be able to continue to operate with the support of government subsidies or soft loans.¹⁸ Tan *et al.* see them as insolvent companies that stay in operation because of subsidies in the form of continual bank loans and/or in the form of overpriced projects awarded by the State.¹⁹ These definitions, whilst pointing out the connections between these unhealthy institutions and government forces, fail to clarify how to differentiate zombie companies from healthy companies.

One commonly-used approach of distinguishing zombie companies from healthy counterparts was offered by Caballero *et al.*, which categorised zombie companies as organisations whose interest payments were less than that would reflect their hypothetical risk, which is commonly referred to as the CHK method.²⁰ Despite its popularity, this categorisation method is not suitable in the context of China, where state-owned banks may not only roll over loans when zombie companies are facing serious financial challenges, but may also give additional loans to assist the zombie companies to make interest payments so that they can continue their daily operation.²¹ In order to establish a more comprehensive and accurate categorisation, Fukuda and Nakamura updated the CHK definition and developed the FN-CHK method, with enhanced criteria of supplementary profitability and evergreen lending.²² The former criterion excludes those companies that have a positive actual profit, and the latter identifies zombie companies as those that are highly leveraged and yet can continue to increase their external borrowings. The FN-CHK method identifies zombie companies primarily through the status of their bank loans, and it is this method that has been broadly applied by Chinese scholars in their analysis of zombie companies.²³

With closer relationship with socio-economic policy in China, the State Council has officially and more broadly defined zombie companies as “companies that are not in line with the national energy consumption, environmental protection, quality or safety standards, that have sustained loss for more than three consecutive years and do not conform to the restructuring direction”.²⁴ Compared with other methods, the categorisation method given by the State Council seems clearer and more practical. In addition, the adoption of policy-connected standards in the definition of zombie

¹⁸ D. Stanway and E. Tham, ‘China Bankruptcies Rise Steadily in 2017 Amid ‘Zombie Firm’ Crackdown’ *Reuters Report* (August 3, 2017) <https://www.reuters.com/article/china-insolvency/china-bankruptcies-rise-steadily-in-2017-amid-zombie-firm-crackdown-idUSL4N1KP2YP>

¹⁹ Tan *et al*, *supra* note 3, at 34.

²⁰ R. J. Caballero, T. Hoshi and A. K. Kashyap, ‘Zombie Lending and Depressed Restructuring in Japan’ (2008) 98 *The American Economic Review* 1943.

²¹ Tan *et al*, *supra* note 3, at 35.

²² Fukuda & Nakamura, *supra* note 9.

²³ E.g., H. Nie, T. Jiang, Y. Zhang and M. Fang, *China’s Zombie Firms: Causes, Consequences and Cure* 中國殭屍企業研究報告——現狀、原因和對策 (Beijing: China Social Sciences Press 2016).

²⁴ State Council of the People’s Republic of China, *The State Council Aims to Eliminate “Zombie Companies” which Make Losses for more than Three Consecutive Years* 国务院清理僵尸企业亏损三年以上央企出清; http://www.gov.cn/zhengce/2015-12/10/content_5022115.htm

companies may give an administrative nature to this economic phenomenon. The connection of zombie companies to policy considerations in part reflects that decisions to designate companies as zombie companies are largely made by the central or local governments.²⁵

The term “zombie company” does not appear formally in Chinese legislation. Reflecting the theme of the article in terms of eliminating zombie companies through insolvency law, we also investigated the definition and scope of zombie companies from the judicial perspective. We searched the texts of judgements for the key phrase 殭屍企業(zombie companies) in an electronic database, China Judgments Online, which publishes all judicial decisions in the country. An analysis of the texts of judgements revealed that the identification of a company as a zombie company is nearly always made upon consideration of certain characteristics, and zombie companies are mostly defined as those with no assets, books, personnel, litigation and business (無資產、無賬冊、無人員、無訴訟, 無經營等 “殭屍企業”狀態).²⁶

Looking at this judicial categorisation and considering the conceptual variations and multiple criteria involved in defining zombie companies, it may be more sensible and valuable to contextualise the characteristics of zombie companies specifically in the Chinese context, rather than attempting to give a precise pan-jurisdictional definition. First, zombie companies in China are those with high amounts of debt but with insufficient corporate assets and books. A rising asset-liability ratio with a clear trajectory of operational losses are typical in these companies. Second, these companies are normally in sunset or backward industrial sectors with increasing domestic and international market pressure, or in deteriorating industry environments in general. Third, these companies are not sufficiently competitive to survive in market conditions and are near or already insolvent with no substantial business activities. Fourth, they are substantially supported by the government through subsidies, or by loans with favourable terms. Fifth, these companies rarely engage in formal lawsuits of any kind.

It may also be observed that from the review of judgments carried out for this article, the companies that have so far been identified and dealt with as zombie companies are typically those who are dormant, rather than those who are ongoing yet lacking

²⁵ For example, in the case 廣東省絲綢紡織集團有限公司 (...遂溪縣金島蠶業有限責任公司...) 強制清算民事裁定書 *Guangdong Silk Textile Group Co., Ltd. (... Suixi County Jindao Silk Industry Co., Ltd...) Compulsory Liquidation Civil Ruling* (2018) 粵 08 清申 6 号 (2018) Guangdong 08 Qingshen No. 6.

²⁶ 惠州市德賽房產開發總公司清算組強制清算民事裁定書 *The Compulsory Liquidation Civil Ruling of the Liquidation Group of Huizhou Desai Real Estate Development Corporation* (2019) 粵 13 强清 12 号 Guangdong 12 Qiangqingshen No. 6.; 廣東 (蛇口) 進出口公司、廣東 (蛇口) 進出口廣州公司強制清算民事裁定書 *Guangdong (Shekou) Import and Export Corporation, Guangdong (Shekou) Import and Export Guangzhou Company Compulsory Liquidation civil ruling* (2018) 粵 01 清申 237 号 Yue 01 Qingshen No. 237.

the capacity to develop, such as Guangdong Jiarui Food Technology Co. Ltd.²⁷ The persistence of these zombie companies might boost statistics but upon closer inspection does not bring about deeper economic improvements and leads to the problems discussed in the next section.

3. Complications Brought by Zombie Companies

Zombie companies potentially pose a very high threat to the economy as a whole, not only because of their own looming insolvency, but also due to the risks that they potentially transfer to other companies such as giving their competitors misleading market information, undermining their level of competitiveness and limiting their capacity for value creation.²⁸ They are regarded as one of the biggest hindrances to promoting an ideal Chinese economic structure.²⁹ Shielding these companies from market forces prevents the more efficient deployment of their assets.³⁰ In recent times this state of affairs has increasingly been at odds with progressive Chinese government policy, reflected in the supply-side reform proposals put forward at the end of 2015 to resolve “structural imbalances” and a slowdown in economic growth.³¹ These reforms consisted of five focused tasks: cutting industrial capacity, reducing the housing inventory, lowering leverage, cutting corporate costs, and improving weak economic links.³² Cleaning up zombie companies is crucial for accomplishing most of these reform tasks. Strategies to liquidate thousands of zombie companies in China are underway in order to address issues of debt and inefficiency and shift investment to more productive use, improving the country’s longer-term growth outlook and avoiding a prolonged slump in economic growth.

However, the exit of a company which has been identified as a zombie company is not always socially desirable, and handling such companies will depend on many factors, including consideration of societal stability and the need for employee resettlement, as well as government strategies and “tasks” of eliminating zombie companies. These explain the reluctance of eliminating zombie companies by the central and local governments in the short term. In the next section, three main complications brought by zombie companies will be discussed.

²⁷ See 廣東省食品企業集團公司、廣東嘉瑞食品科技有限公司破產民事裁定書 *The civil ruling on bankruptcy of Guangdong Food Enterprise Group Company and Guangdong Jiarui Food Technology Co., Ltd.* (2019)粵破終 43 號 Guangdong Po Final No. 43

²⁸ A.G. Ahearne and N. Shinada, ‘Zombie Firms and Economic Stagnation in Japan’ (2005) 2 *International Economics and Economic Policy* 363.

²⁹ X. Zhang and J. Keith, ‘From Wealth to Power: China’s New Economic Statecraft’ (2017) 40 *The Washington Quarterly* 185 at 193.

³⁰ M. White, ‘The Corporate Bankruptcy Decision’ (1989) 3 *Journal of Economic Perspectives* 129.

³¹ J. Boulter, ‘China’s Supply-Side Structural Reforms’, *Reserve Bank of Australia Bulletin* December 2018, <https://www.rba.gov.au/publications/bulletin/2018/dec/pdf/chinas-supply-side-structural-reform.pdf>

³² Xinhua, *Xinhua Insight: Xi’s vision on deepening reform* (23rd February 2017) http://www.xinhuanet.com/english/china/2017-02/23/c_136079929.htm

3.1 Misallocation of Social Resources and Unfair Competition

Various approaches have been applied to prop up zombie companies, many involving government interference or government subsidies³³ such as favourable terms in public procurement contracts, additional loans, favour in the payment of long-term loans, or loans with lower interest rates. This bailing out of zombie companies could be economically detrimental to society, in unfairly or even illegitimately taking up shares of limited social resources, especially those from the State, as well as presenting a moral hazard problem. It may also be regarded as locking up talent and other resources that should have been available to more successful and dynamic companies.³⁴

Favour has mainly been shown to companies, especially SOEs, which enjoy protection either from the central or local governments. In 2018, the number of loss-making SOEs reached 781000 companies.³⁵ The Chinese economic development model involves intense inter-provincial competition,³⁶ and local governments are reluctant to see their local companies enter insolvency proceedings, even where these companies are in financial difficulties and have uncompetitive products or bad loans. The analysis above of companies characterised as zombie companies suggests that these companies, able to trade only with state support, are not yet coming before the courts, or exiting the market in other ways.

Admittedly, investments and subsidies may be necessary in the short term to save zombie companies from exiting the market abruptly and causing significant impacts for employees and wider society. This financing may even improve their performance in relation to output growth, job security and creation, the success of the restructurings of Guangdong Salt Industry Group in 2020 and Tianjin Pipe Corporation in 2019 being good examples. However, tolerance of zombie companies through subsidies may waste large amounts of natural and social resources and eventually distort the effectiveness of the banking system as well as the economy as a whole, potentially leading to systemic failure and crisis. Government aid is problematic from the perspective of competition, as it will make it difficult for companies with high production efficiency and superior business conditions to fully benefit from their advantages, since healthy companies do not tend to benefit from resources within this limited pool. The resource mismatch will affect the long-term

³³ W. R. Lam, A. Schipke, Y. Tan and Z. Tan, 'Resolving China Zombies: Tackling Debt and Raising Productivity' *IMF Working Paper* WP/17/266, pp.9-10.

³⁴ K. Liu and N. Mao, 'A Foreign Literature Review of Zombie Companies Research' (2016) 38 *Foreign Economics & Management* 3.

³⁵ Ministry of Finance of China, 2019 China Fiscal Yearbook (Beijing: China State Finance Magazine 2020)

³⁶ See J.H. Chung, 'Shandong's Strategies of Reform in Foreign Economic Relations: Preferential Politics, Entrepreneurial Leadership, and External Linkage' in P.T.Y Cheung, J.H. Chung and Z. Lin (eds.), *Provincial Strategies of Economic Reform in Post-Mao China: Leadership, Politics and Implementation* (Routledge 1998) 253.

development of the economy,³⁷ and can therefore result in unfairly “crowding out” healthy companies by distorting resource allocations.³⁸ These distortions may undermine the transformation of China’s economy,³⁹ as a sustainable and competitive market is key for sustainable economic development.⁴⁰ In spite of the potential short-term benefits of subsidies, it is nevertheless desirable that government assistance for zombie companies should be offered with great care in order that market competition can be promoted and the efficiency can prosper.

3.2 The Potential Social Hazards of Zombie Companies’ Exits

The support of zombie companies is closely related to the need to maintain social stability. Where zombie companies are pushed out of the market, the social service function that they typically would perform needs to be absorbed by the government, including through unemployment aid and funding for social security liabilities. Given the potential for business closures to lead to social problems and associated costs, it is unsurprising that the government may be tempted to bail out zombie companies, particularly when they employ a large number of employees and the losses of these jobs may cause significant societal problems. The resettlement of redundant workers becomes the most prominent social cost of dissolving zombie companies.⁴¹ Redundancies and lay-offs arising out of corporate restructuring and privatisation have eroded the state workers’ contract known as the iron rice-bowl.⁴² Concerns regarding social stability and effects of redundancy provide officials with the motivation to keep companies alive, with their workers continuing in employment with their pensions intact, especially for vulnerable groups.⁴³ Negative social impacts caused by placing zombie companies in insolvency procedures in China are occasionally inevitable and could be a serious concern for China, particularly in SOEs.⁴⁴

³⁷ J. Liang, ‘Can “Zombie Enterprises” Find Self-Help Road through Technological Innovation?’ (2017) 6 *Chinese Studies* 173 at 174.

³⁸ G. Shen and B. Chen, ‘Zombie Firms and Over-capacity in Chinese Manufacturing’ (2017) 44 *China Economic Review* 327 at 341.

³⁹ See introduction chapter of Ning Wang (ed.), *China’s Market Transformation: Origins, Protagonists, and Processes* (World Scientific Publishing 2019).

⁴⁰ S. Li, ‘Eliminating Zombie Companies through Corporate Insolvency Regime 通過破產制度實現“殭屍企業”的破產出清’ (2018) 23 *People’s Tribune 人民论坛* 98 at 98.

⁴¹ W. Wu, ‘Death by a Thousand Job Cuts: the Human Cost of China’s Zombie Firms’ (07 March, 2017) *South China Morning Post*, <https://www.scmp.com/business/commodities/article/2076401/human-cost-chinas-failing-industrial-soes>

⁴² C. Coonan, ‘Demise of ‘Iron Rice Bowl’ brings social change in Chongqing’ *Irish Times*, April 28, 2016.

⁴³ See *Civil Judgment of Second Instance of Dissolution Dispute between Yixing v Beijing Anfangda Technology Co., Ltd.* 衣行與北京安方達科技有限公司公司解散糾紛二審民事判決書 (2018) Beijing 01 Min Final 4908 京 01 民終 4908 号.

⁴⁴ Y.T. Wong, ‘Trust, Job Security and Subordinate-supervisor *Guanxi*: Chinese Employees in Joint Ventures and State-owned Enterprises’ (2018) 24 *Asia Pacific Business Review* 638.

However, the imperative for sustainable economic growth in China reminds us that these bail-out mechanisms may only maintain social stability in the short term.⁴⁵ Bank loans and social resources for the maintenance of zombie companies give rise to a temporary, illusionary stability by maintaining employment volume at the cost of long-term social prosperity.⁴⁶ From a positive point of view, advances in national economic strength and improved social security⁴⁷ may mean that the authorities will be in a better position to deal with the issue of laid-off employees when eliminating zombie companies, enabling greater use of market-based approaches.

3.3 Reluctance to Initiate Insolvency Procedures

Reluctance to initiate insolvency procedures is manifest in many aspects in China. First, it may exhibit from the design and enforcement of legislation. The Enterprise Bankruptcy Law of China (EBL) was enacted after many years of effort, in response to both domestic need and pressure from external relations. The text of the EBL is brief, with few provisions and limited details, and specific mechanisms for dealing with insolvency in public institutions have not been fully established.⁴⁸ Possible court biases combined with limited capacity to take cases, as well as a lack of expertise among judges and insolvency practitioners make cases for resolving zombie companies through insolvency procedures a challenging prospect.

Significant pressure to resist the opening of insolvency proceedings in relation to failing companies can come from the employees of the debtors, in particular those of SOEs, where employees are likely to be very reliant on the companies and have limited prospects for re-employment after redundancy.⁴⁹ Moreover, creditors may feel reluctant to initiate insolvency procedures considering the low expected recovery rate. Equally perturbing, local governments may also be reluctant to initiate procedures. In addition to the lack of knowledge about insolvency regimes among the leaders of local governments, entering insolvency procedures will have negative impact on reputation and political achievements of local governments. It was further reported that because some local governors are likely to be employed on a short-term basis, with potential career movement to be promoted to higher levels, they may only be interested in the so-called “face project (面子工程)” and “political performance project (政绩工程)”,⁵⁰ namely boosting the short-term interest of a

⁴⁵ See D. de Rambures and F.E. Duenas, *China's Financial System: Growth and Inefficiency* (Palgrave Macmillan) 3–4;

⁴⁶ X. Jiang, S. Li and X. Song, ‘The Mystery of Zombie Enterprises – “Stiff but Deathless”’ (2017) 10 *China Journal of Accounting Research* 341 at 341–342.

⁴⁷ See China Labour Bulletin, ‘China's Social Security System’, *China Labour Bulletin*, <https://clb.org.hk/content/china%E2%80%99s-social-security-system>

⁴⁸ W. Wang and M. Gao, ‘The Necessity of a Personal Insolvency System in China’ (21 March 2018) *China Business Law Journal*, <https://www.vantageasia.com/the-necessity-of-a-personal-insolvency-system-in-china/>

⁴⁹ J. Sheehan, J. Morris and J. Hassard, ‘Redundancies in Chinese State Enterprises: A Research Report’ (2002) 39 *Industrial Relations* 486.

⁵⁰ Nie *et al*, *supra* note 23, at 65–66.

company to benefit their promotion and political achievements, disregarding long-term strategic goals or issues.

Despite the reluctant attitudes of certain local governments, both internal and external pressures have led to changes in policy, as discussed in the next section. The effective implementation of these policies, as far as they reflect the adoption of a more market-based approach, requires institutional reforms including a system of corporate insolvency laws and the infrastructure to support it. This must involve experienced accountants, insolvency professionals and judges with an understanding of the complexities of insolvency proceedings, as discussed in the last section.⁵¹

4. A Change of Policy

The changing approach to zombie companies is part of the broader programme of supply-side reforms announced by President Xi in late 2015. Sustainable economic development has increasingly been regarded as one of the biggest challenges for China, particularly after the 2008-10 global financial crisis.⁵² Prior to that time state policies which favoured uneconomic loans to SOEs were considered to have inhibited private sector growth as well as enabling zombie companies to endure.⁵³ A programme of sustainable development in China, with a more competitive financial and legal system and increased opportunities for all, depends on economic developments geared towards the renovation and advancement of new products and the application of more efficient production mechanisms according to theories of economic innovation and the business cycle.⁵⁴ These imperatives will only be heightened following the Covid-19 pandemic. The sustainable development process requires the eradication of out-dated products and obsolete techniques and systems. In this metabolism, priorities should be given to the creation and expansion of innovative companies with promising potentials, while accelerating the process of driving zombie companies out of the market.

In keeping with reform imperatives an “exit policy” has been adopted, setting targets for the elimination of companies for which regulatory failure has led to outdated production capacity. Relevant policies were announced during the 11th Five-Year Plan (2006-2010) and the 12th Five-Year Plan (2011-2015) periods.⁵⁵ The

⁵¹ R. Parry and H. Zhang, ‘China’s New Corporate Rescue Laws, Perspectives and Principles’ (2008) 1 *Journal of Corporate Law Studies* 113; R. Parry & Y. Long, China’s Enterprise Bankruptcy Law, Building an Infrastructure Towards a Market-Based Approach, (2020) 20 *Journal of Corporate Law Studies* 157.

⁵² The annual GDP growth rate decreased from 10.6 in 2010 to 6.11% in 2019. World Bank, GDP Growth (Annual %) – China, available at <https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?end=2016&locations=CN&start=1961&view=chart>.

⁵³ Tan *et al*, *supra* note 3, 33.

⁵⁴ J. A. Schumpeter, *Capitalism, Socialism and Democracy*. (Routledge 1994) pp.82–83.

⁵⁵ For an introduction to 1st to 12th Five-Year Plans see “The History of the Chinese Communist Party” available via <http://dangshi.people.com.cn/GB/151935/204121/index.html>.

policies require the elimination of zombie companies with production requirements that entail high-energy consumption, high pollution levels and backward technological conditions. In a State Council meeting in relation to the Chinese industrial development trajectory during this critical transformative period, Premier Li stressed that the government needed to “accelerate reorganisation of the zombie companies and assist these companies to withdraw from the market whereas more support should be offered to SOEs to resolve the historical baggage.”⁵⁶ The Central Economic Work Conference in 2016 also raised the policy of “tackling zombie companies as a central task”, in order to reduce leverage levels and lower corporate costs.⁵⁷ The State-owned Assets Supervision and Administration Commission (SASAC) of the State Council set a definite target of dissolving 300 zombie companies in 2017, and some provincial SASACs had already by 2017 announced their positive achievements towards the targets set by central government.⁵⁸ Most prominently, the administrations in two relatively commercially advanced areas, Guangdong Province and Zhejiang Province, were reported by 2017 to have closed 2,394 and 555 zombie companies respectively, most of these having been fully or partially state-owned.⁵⁹

In late 2018 the National Development and Reform Commission issued more elaborate processes for the elimination of zombie companies, emphasising a market-based approach but with government guidance in debt disposal plans through liquidations, reorganisations and mergers with a target to complete all disposal work by the end of 2020.⁶⁰ Significant progress was subsequently made and in July 2019 thirteen departments in China, including the National Development and Reform Commission, the China Securities Regulatory Commission, the Ministry of Human Resources and Social Security, and the Supreme Court, jointly issued the “Reform Plan for Accelerating the Improvement of the Market Player Withdrawal System (hereinafter Reform Plan)”.⁶¹ The plan sets out provisions to regulate methods of market player withdrawal, provides further clarity as to these methods, and also establishes several supporting systems. In a 2019 statement, Premier Li reiterated the State’s intention to address the problem of zombie companies,⁶² and the disposal of

⁵⁶ The State Council of the People’s Republic of China, http://www.gov.cn/guowuyuan/2015-11/05/content_5004881.htm

⁵⁷ H. Xu, ‘Setting the Tone for 2017 – The Central Economic Work Conference’ (29 Dec, 2016), *China and US Focus*.

⁵⁸ Y. Du, ‘SASAC: Disposing of 300 Zombie Companies 2017 国资委: 今年处置 300 户 “僵尸企业” (16th May 2017) *Securities Daily 证券日报*.

⁵⁹ S. Liu, S. Chen, W. Chen, B. Wang, Y. Mao and M. Li, ‘Disposal of “Zombie Companies”: How to Settle this “Bovine Nose” 处置 “僵尸企业”, 这个“牛鼻子”怎么抓?’ *Xinhua News* (4th March 2017) http://www.xinhuanet.com/politics/2017-03/04/c_1120568232.htm

⁶⁰ ‘Notice on Steps to Deal with Zombie Companies and Eliminate Over-Capacity’ http://www.gov.cn/xinwen/2018-12/04/content_5345675.htm

⁶¹ 关于印发《加快完善市场主体退出制度改革方案》的通知; 发改财金〔2019〕1104号, http://www.gov.cn/guowuyuan/2019-07/16/content_5410058.htm

⁶² Li Keqiang, ‘Report on the Work of the Government’ delivered at the Second Session of the 13th National People’s Congress of the People’s Republic of China on March 5, 2019.

zombie companies is seen to be in line with market-based principles and the rule of law.⁶³

Against this background, local governments have stepped up the pace of exiting zombie companies from the market through both administrative measures and market-oriented resolutions. These measures include mergers and takeovers,⁶⁴ de-registrations and other market-based measures to force closure, including some use of insolvency procedures such as liquidation, reorganisation and conciliation.

Official avowals of the use of market-based approaches in eliminating zombie companies have however been patchy in China, as a country with a hybrid and transformative corporate governance structure combining administrative and economic features. Administrative measures are still predominantly adopted by some local governments, which seems contradicting with the governments' promise and intention of reliance on market power, and undermining the prospect of giving companies autonomy.⁶⁵

Although government policy in China has helped in eliminating zombie companies in the short term, there is still significant progress to be made to establish an effective exit mechanism that functions under the socialist market economy and a rule-based framework, particularly in the still-dominant SOE sectors.⁶⁶ Considering that the government policy and administrative interference are both necessary and unavoidable in the short-term in a country with socialist market economy, a realistic and sustainable model for disposing of zombie companies should be a hybrid one. This is a dynamic hybrid model that changes with institutional enlivenment in Chinese society as a whole. It echoes the 2019 'Reform Plan'⁶⁷ which regarded "strengthening the coordination of and cooperation between the judicial authorities and the administrative authorities" as a key element in order to achieve a balanced case-handling system under the EBL.

https://www.wsj.com/public/resources/documents/2019NPCWorkReportEN.pdf?mod=article_inline

⁶³ National Development and Reform Commission, 'Notice on Steps to Deal with Zombie Companies and Eliminate Over-Capacity' http://www.gov.cn/xinwen/2018-12/04/content_5345675.htm.

⁶⁴ Under an approach of 'grasping the big and letting go of the small' the establishment of larger enterprises was prioritised: C.K. Lee, *Against the Law: Labor Protests in China's Rustbelt and Sunbelt* (University of California Press, 2007) 49.

⁶⁵ W. Chi and Y. Wang, 'The "Grabbing Hand" and Corporate Governance in China', in M. Nakamura (Ed.), *Changing Corporate Governance in China and Japan: Adaptions of Anglo-American Practices* (Palgrave 2008) 87.

⁶⁶ M. J. Whincop, *Corporate Governance in Government Corporations* (Ashgate 2005) 52.

⁶⁷ *Supra* note 61.

5. Market-Based Approaches to Tackle the Problems Brought by Zombie Companies in China: The Role of Insolvency Law

Using insolvency procedures for the exit of zombie companies should be seen as an important component in the reform towards a hybrid model. The effective handling of cases requires not only the development of insolvency law and procedures, but also the establishment of communication channels for the government, courts, insolvency practitioners and banks to settle the social problems created by the dissolution of zombie companies, considering China's imperfect social security system and employee salary guarantee system.⁶⁸ The next section will consider the feasibility of application of the existing insolvency law to zombie companies and the necessity of proposing new legislative changes for zombie companies to boost Chinese economic development through an improved insolvency law regime. This section will showcase successful experiences at the local level with the purpose of improving the corporate insolvency mechanism nationally to facilitate a more effective environment for eliminating zombie companies.

5.1 Setting the Scene: Functions and Development of Insolvency Law in China

In the absence of externalities that would demand a different approach, corporate insolvency systems are the logical avenue for resolving the affairs of zombie companies, providing a collective, orderly mechanism for debt resolution. In response to the challenges brought by zombie companies, the OECD suggested that insolvency law should include measures to: (1) "reduce the share of capital sunk in zombie firms, which in turn spurs the reallocation of capital to more productive firms; (2) revive weak firms by raising the likelihood that zombie firms subsequently return to better financial health and the weakest non-zombie firms avoid turning into zombies, and facilitate technological diffusion by promoting experimentation; and (3) provide laggard firms with the scope to implement the necessary business changes to move closer to the technological frontier".⁶⁹ There is a general focus on rescuing companies and a fair distribution of resources. An effective insolvency regime will reduce the barriers to restructuring among weak companies and promote a healthy mechanism for recognising, dealing with and possibly reconstructing zombie companies, protecting society and employees as well as other stakeholders affected by the insolvency.

If effectively enforced and fairly applied, the insolvency procedures under the EBL could provide a powerful channel for the disposal of zombie companies. Reorganisation may solve the debt problem that undermines the development of companies and save zombie companies that still have commercial value, such as the reorganisation of Nanjing Tanker Corporation and CNNC Hua Yuan Titanium Dioxide Company Ltd. These procedures may not only sometimes rescue the debtor,

⁶⁸ H. Zhao, *Government Intervention in the Reorganisation of Listed Companies in China* (Cambridge University Press, 2019), 241.

⁶⁹ D. Andrews, M.A. McGowan and V. Millot, 'Confronting the Zombies: Policies for Productivity Revival' *OECD Economic Policy Paper* No. 21 (2017) p.6.

but also protect the interests of creditors, as well as promoting the interests of the wider community. Conciliation with creditors under insolvency law may also provide a useful channel for the disposal of zombie companies by facilitating bargaining between creditors and the debtor in order to reach an agreement that is binding on all creditors.

5.2 Creditors' Meetings and the Necessity of Listening to Creditors' Voices

A more market-based footing for insolvency proceedings may be promoted through creditor empowerment, giving them a voice in the management and distribution of the debtor's assets. Creditors become residual claimants to the company's assets in cases of insolvency and face the increased moral hazard normally taken on by shareholders, who are willing to gamble with their equity claims depleted.⁷⁰ To facilitate collective action by creditors, formal insolvency law has placed necessary constraints on their private bargaining powers.⁷¹ The formal rules of insolvency can reduce individual creditors' incentives to hold out and therefore prevent asset dissipation and premature liquidation of the debtor.⁷²

The EBL includes a vehicle for creditor empowerment in the form of the creditors' meeting, the basic mechanism for creditors' participation and decision-making in insolvency proceedings. Under the EBL, all creditors whose claims are confirmed by the court have the right to attend the meeting and vote⁷³ on issues such as sale of assets and any reorganisation plan.⁷⁴

However, when creditors are heterogeneous and scattered, holding a creditors' meeting may be inefficient and costly. An important institution to facilitate the active participation of creditors and strengthen the decision-making power of the creditors' meeting is the creditors' committee, which can advise creditors on key issues and interact with the debtor and administrator on their behalf.⁷⁵ Under the EBL, the creditors' meeting may establish a creditors' committee composed of no more than nine members, with at least one elected representative of the employees or the union.⁷⁶ The creditors' committee monitors the administrator especially regarding the management and disposal of assets, and can require the administrator and managers of the debtor company to account for their duties.⁷⁷ The creditors' committee may require the administrator to explain the disposition of assets, or to rectify matters if the creditors' committee believes that the disposition by the administrator does not conform to the plan for managing the debtor's assets as

⁷⁰ J. Velasco, 'Shareholder Ownership and Primacy' [2010] *University of Illinois Law Review* 897.

⁷¹ T. H. Jackson, 'Bankruptcy, Non-Bankruptcy Entitlements, and the Creditors' Bargain' (1982) 91 *Yale Law Journal* 857.

⁷² D. T. Brown, 'Claimholder Incentive Conflicts in Reorganization: The Role of Bankruptcy Law' (1989) 2 *The Review of Financial Studies* 109.

⁷³ Article 59, EBL 2006.

⁷⁴ *Ibid.*, article 61.

⁷⁵ 'UNCITRAL Legislative Guide on Insolvency Law', articles 110-112.

⁷⁶ Article 67, EBL 2006.

⁷⁷ *Ibid.*, articles 68, 69.

approved by the creditors' meeting.⁷⁸ However, in practice, a lack of incentive and expertise among most creditors to investigate the business or scrutinise the reorganisation plan undermine the monitoring role of the creditors' committee.⁷⁹

A strengthened role for banks is generally desirable as part of the creditor voice as they are the major creditors of Chinese companies. Their participation can balance the power of local government and monitor decision-making by the administrator and management. In the 2018 Notice on Carrying on Debt Disposal of Zombie Companies issued by 11 ministries, including the National Development and Reform Commission (NDRC),⁸⁰ it is stated that for zombie companies that still have business value, financial creditors' committees are encouraged to negotiate with other creditors, conduct debt restructuring, and introduce strategic investors for merger and restructuring of the debtor. Allowing creditors to negotiate and conduct market-based restructuring of zombie companies can maximise value for creditors, avoid the one-size-fits-all liquidation of all, and may have positive effects on regional employment and social stability.

The participation of creditors still rests at the level of "encouragement" and we propose mandatory creditors' meetings when restructuring zombie companies, as a forum for creditors' bargaining. It has been proposed that the insolvency administrator should be appointed by the creditors' meeting,⁸¹ rather than the courts as provided by the current law.⁸² In addition, the accessibility of the creditors' meeting should be enhanced. One of the most promising developments in this regard is usage of technology to increase the participation of creditors that are scattered geographically. For example, it has become common for Chinese courts to organise online creditors' meetings to reduce costs for creditors and improve the participation.⁸³ More recently, in the reorganisation of a hardware company in Hangzhou, most creditors participated in the first creditors' meeting remotely via teleconference, and the voting was verified through blockchain technology.⁸⁴ As each participant in the blockchain can have a copy of the ledger that records all the information, blockchain technology offers decentralised, transparent and secure

⁷⁸ Article 15, Provisions (III) of the Supreme People's Court on Several Issues concerning the Application of the Enterprise Bankruptcy Law [最高人民法院关于适用〈中华人民共和国企业破产法〉若干问题的规定].

⁷⁹ E. S. Adams, 'Governance in Chapter 11 Reorganizations: Reducing Costs, Improving Results' (1993) 73 *Boston University Law Review* 581, 614-615.

⁸⁰ NDRC etc., 'Notice on Carrying on Debt Disposal of Zombie Companies [關於進一步做好“殭屍企業”及去產能企業債務處置工作的通知关于进一步做好“僵尸企业”及去产能企业债务处置工作的通知] (2018) http://www.gov.cn/xinwen/2018-12/04/content_5345675.htm.

⁸¹ The PBC School of Finance, 'Supply-Side Structural Reform and Improvement of Bankruptcy Law [供給側結構性改革與破產法的完善] (2016) http://www.pbcfs.tsinghua.edu.cn/Upload/file/20160623/20160623073706_3990.pdf.

⁸² Article 13, EBL 2006.

⁸³ See National Enterprise Bankruptcy Information Disclosure Platform, <https://pccz.court.gov.cn/pcajxxw/index/xxwsy>

⁸⁴ C. Wang, 'A District Court in China Trials Blockchain E-Voting for Bankruptcy Case' (2018) <https://news.8btc.com/a-district-court-in-china-trials-blockchain-e-voting-for-bankruptcy-case>

governance.⁸⁵ With new technological developments such as online conferences and blockchain, the information disclosure of the debtor company can be enhanced and it will be easier to coordinate creditors and enable them to vote and deliberate. As the financial situation in zombie companies is always complex, a technology-enhanced insolvency procedure will potentially improve efficiency and transparency in the process of 'bargaining' in zombie companies and lead to fairer results.

5.3 Insolvency Tribunals, Insolvency Courts and Other Judicial Resources

The courts will play a central role in resolving zombie companies on a market-based footing with objective case handling. However progress has been hampered in some cases by limited judicial resources or judges' inexperience in insolvency matters limiting their skills and knowledge.⁸⁶ The judges' knowledge is particularly important not only on the identification and characterisation of zombie companies, but also in filing insolvency cases, so that some rescuable zombie companies might instead take the route of reorganisation before too many creditors enforce their debts in court.

The development of cross-regional specialised courts will constrain local protectionism and enhance the efficiency of adjudication.⁸⁷ In addition, specialised judges are more likely to produce consistent decisions in a more efficient way.⁸⁸ Judges can accumulate experience and in-depth knowledge through adjudicating many similar cases. They are usually better at resolving highly technical issues in complex cases such as the insolvency of zombie companies.

The wide use of specialist bankruptcy courts in the US⁸⁹ has provided some evidence in favour of the benefits of specialisation. Studies have pointed out that some US jurisdictions have attracted more bankruptcy cases than others because of the expertise and efficacy of their bankruptcy courts.⁹⁰ The significance of the specialist judges' expertise and experience is also supported by an empirical study which found that it takes on average up to four years for a judge to manage large

⁸⁵ R. Mangano, 'Improving Cooperation in Cross-Border Insolvency Issues by Means of Blockchain Technology' (2016) http://www.uncitral.org/pdf/english/congress/Papers_for_Congress/130-MANGANO-improving_cooperation_in_cross-border_insolvency_.pdf.

⁸⁶ See T. Gong, 'Dependent Judiciary and Unaccountable Judges: Judicial Corruption in Contemporary China' (2004) 4 *China Review* 33.

⁸⁷ M. Zimmer, 'Overview of Specialized Courts' (2009) 2 *International Journal for Court Administration* 46.

⁸⁸ *Ibid.*

⁸⁹ The bankruptcy courts in the US are evenly and widely located as Federal Judiciary has 90 bankruptcy courts, one in almost each judicial district; see United States Courts, U.S. Bankruptcy Courts - Judicial Business 2016, <https://www.uscourts.gov/statistics-reports/us-bankruptcy-courts-judicial-business-2016#:~:text=The%20Federal%20Judiciary%20has%2090,which%20share%20a%20bankruptcy%20court>.

⁹⁰ K. Ayotte and D. Skeel, 'Why Do Distressed Companies Choose Delaware? An Empirical Analysis of Venue Choice in Bankruptcy' (2004) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=463001.

Chapter 11 filings, but more experienced judges spend less time in bankruptcy cases. With more experienced judges, the debtor is more likely to be kept as a going concern and produce a higher recovery rate for creditors.⁹¹

Positive steps have been taken over the last decade in China towards the establishment of more specialised insolvency courts. As transitions, government initially established liquidation and insolvency tribunals (*qingsuan yu pochān shēnpántīng* 清算與破產審判庭) within the intermediate people's courts in sub-provincial cities and provincial capital cities.⁹² This is an attempt to concentrate the trial of insolvency cases within the intermediate courts and reduce the kind of government intervention that is most prevalent in lower-tier courts.⁹³ The establishment of tribunals has facilitated a significant increase in the numbers of accepted insolvency law cases. In addition, as shown in empirical research, the establishment of insolvency tribunals in China has improved the efficiency of the insolvency procedures for zombie companies, reduced the influence of local government, and decreased the cost of capital for privately-owned companies.⁹⁴

Considering the large quantity and complexity of zombie companies and the fact that many cases have not entered the judicial process at all in China, the professionalism of the tribunals and their judges will be key in the disposal of these companies. In the 'Opinions on Providing Judicial Protection for Improving Business Environment' issued in 2018, the SPC pointed out that to improve the environment for doing business in China, the professionalism of judges and insolvency administrators should be further strengthened. Professional judges must be trained and the evaluation system must be changed in order to improve judges' incentives to adjudicate insolvency cases.⁹⁵ Current judicial systems and practices in China carry many localised characteristics and problems such as a lack of expertise and the absence of case law or guiding cases mean that the application of insolvency law to zombie companies is a challenging task.

To address these concerns and build institutional capacity, led by judicial and social necessities, specialised insolvency courts were subsequently established in China with the aim of dealing with zombie companies. The first insolvency court was

⁹¹ B. Iverson and others, 'Learning by Doing: Judge Experience and Bankruptcy Outcomes' (2018) http://beniverson.org/papers/IMWX_PracticePerfect.pdf. For rising concerns about judicial capacity arising from the Covid-19 pandemic recently, see B. Iverson and M. Roe, 'Planning for an American Bankruptcy Epidemic' *Project Syndicate* 5 May 2020 <https://www1.project-syndicate.org/commentary/america-looming-bankruptcy-epidemic-by-ben-iverson-and-mark-roe-2020-05>.

⁹² Section 2.1, Notice of the Supreme People's Court on Issuing the Minutes of the National Court Work Conference on Bankruptcy Trials 2018

⁹³ 'Fourth Five-Year Reform Outline of the People's Court (2014-2018) [人民法院第四個五年改革綱要]' (2014), <http://www.court.gov.cn/zixun-xiangqing-8168.html>.

⁹⁴ B. Li and J. Ponticelli, 'Going Bankrupt in China' (2020) Centre for Economic Policy Research Discussion Paper DP15007.

⁹⁵ SPC, 'Opinions on Providing Judicial Protection for Improving Business Environment [關於為改善營商環境提供司法保障的若干意見]' (2017) <http://www.court.gov.cn/zixun-xiangqing-56132.html>.

established in Shenzhen in December 2018, as an affiliate to the Shenzhen Intermediate Court.⁹⁶ Similar insolvency courts were also established in Shanghai, Beijing, Tianjin, Guangzhou and Wenzhou.⁹⁷ Compared with insolvency tribunals, the new insolvency courts are more developed, with staff, workplaces and other resources specifically allocated for insolvency trials. The judges are also notably more experienced than ordinary judges. For example, 83% of the judges in the Beijing bankruptcy court have postgraduate qualifications, with an average trial experience of 12 years.⁹⁸

These courts are likely to play a significant role in resolving zombie companies through formal insolvency procedures, and improve the efficiency and effectiveness of bankruptcy trials. As the emergence of each zombie company has its own policy and historical roots, the approach to disposal for each company should not follow a unified trajectory. Specialised courts and judges will provide judicial expertise to facilitate case-by-case investigation on the appropriateness of dealing with zombie companies through the most suitable insolvency procedure, rather than simply liquidating the companies. In accordance with the OECD principles noted above, the focus should not solely be on liquidation.

In order to constrain localism and improve judicial expertise, more measures might be necessary in the future, such as establishing national insolvency courts and appointing specialised insolvency judges even in courts of lower levels. However, there will be foreseeable institutional and practical obstacles in the way of implementing these measures. For example, it might be difficult to give special status to these judges at lower levels regarding their job security, remuneration and evaluation, considering the institutional constraints. Administrative pressures from central and local governments, judicial accountability and judicial independence might also make the decisions of judges sometimes difficult. In addition, it will be difficult to prescribe clear divisions in jurisdiction between national insolvency courts and the local courts. Furthermore, learning from the US experience, a more geographically balanced approach is a major area to be developed, paying special attention to establishment of insolvency courts in less developed areas where zombie companies pose more serious threats to the economic development and social security, such as Northeast and Southwest China.

⁹⁶ H. He and L. Alvin, 'Shenzhen's New Bankruptcy Court Could Track Assets Transferred to Hong Kong' (South China Morning Post, 2019) <https://www.scmp.com/economy/china-economy/article/2182479/bankrupt-tycoons-beware-new-court-china-could-track-funds>.

⁹⁷ Bankruptcy Law Review, 'Six Bankruptcy Courts in China [全國六大破產法庭]' (2019) <http://m.zichanjie.com/article/547527.html>

⁹⁸ S. Ren, '83% of Judges in Beijing Bankruptcy Court Have Postgraduate Education [北京破產法庭法官團隊研究生以上學歷占比 83%]' (Beijing Daily, 2019).

5.4 Administrators and Liquidation Committee

The EBL 2006 established an ostensibly market-driven system in which insolvency proceedings would be implemented by a newly established administrator, an independent intermediary who would conduct cases impartially, free of state administrative influence. However, this market-orientated approach was adopted with two important exceptions, namely where the proceedings are managed either by a debtor-in-possession⁹⁹ or by a liquidation committee. The latter will be considered later in this section whereas the administrator system will be examined first.

5.4.1 Administrators

The use of an administrative system of qualified practitioners with specialist insolvency expertise is part of the move towards more market-based insolvency proceedings. This approach can offer significant advantages, and has given rise to successful restructurings of SOEs. Various social intermediaries are eligible to act as administrators,¹⁰⁰ including not only law and accounting firms¹⁰¹ but also some specialist liquidation firms. To limit the potential for bias the administrator is to be appointed by the court upon the opening of insolvency proceedings,¹⁰² selected from a roster established by the company's local court¹⁰³ normally according to some neutral means, such as a random drawing or a 'cab rank' system. However, these approaches could give rise to the appointment of a person of insufficient expertise or experience in a large or complex case, and therefore the roster may be departed from in various circumstances.¹⁰⁴

In addition, in spite of the market-oriented impression that an independent administrator might give, the system has in practice been subject to state administrative influence. It has been notable that local governments have tended to exert influence over the conduct of insolvency cases¹⁰⁵ in the interests of social stability. Recently there have been indications that this influence is declining in provinces with more advanced insolvency systems,¹⁰⁶ including Guangdong and Zhejiang Provinces which, as previously noted, have taken significant steps towards eliminating zombie companies from the market.¹⁰⁷ These successful experiences may

⁹⁹ EBL 2006, Art 73.

¹⁰⁰ EBL 2006, Art 24.

¹⁰¹ Individuals with specialist expertise can apply to be appointed to the roster as individuals; Art. 3, Appointment Regulations. However, the expectation is that they will handle only simple cases.

¹⁰² EBL 2006, Art 15.

¹⁰³ Art 1. 'Regulations of the Supreme People's Court on the Appointment of Administrators for Hearings on Cases of Enterprise Bankruptcy'.

¹⁰⁴ *Ibid*, Art 15.

¹⁰⁵ Z. Zhang, *Corporate Reorganisations in China: An Empirical Analysis* (Cambridge University Press 2018), 81–85.

¹⁰⁶ Steele *et al*, *supra* note 4.

¹⁰⁷ CBN Editor, 'Local Governments Set to Accelerate State-owned Enterprise Reforms' *China Banking News* 24 January 2018.

be more broadly introduced in less developed areas whose economic development may be more badly hit by the elimination of zombie companies.

5.4.2 Liquidation Committees

Given the social importance of many zombie companies, however, it is more likely that their cases will be handled by a liquidation committee, rather than an administrator. The EBL 2006 retained the possibility of the appointment of such a committee composed of various government officials, which was the means of governance of insolvency cases under the previous, highly state-controlled planned EBL.¹⁰⁸ Section 24 of the EBL 2006 provides that “the post of insolvency administrator may be assumed by a liquidation committee comprised of the relevant departments and organs or by such social intermediary agencies such as a law firm, an accounting firm, a insolvency liquidation firm that have been established according to law”. Such an appointment can be made in place of an administrator in various circumstances,¹⁰⁹ including the insolvencies of SOEs and in other cases where the court considers this appropriate.¹¹⁰ Therefore, it might be expected that the position in relation to socially important zombie companies is that the liquidation committee approach will be taken, and there are accordingly likely to be high levels of state involvement in such cases.

Despite its relatively effective role in resolving insolvency in China, the fairness and nature of liquidation committees have received some doubts. Wang argued that these committees potentially undermined the legislative aims of the EBL 2006, which were to establish and promote professionalism among insolvency practitioners by allocating insolvency issues to these parties instead of to civil servants or government officials who lack basic legal knowledge, experience or expertise in such cases.¹¹¹ In practice, it is sometimes hard to hold these committees to account for their decisions, given that most committee members are powerful government officials.¹¹² For SOEs, these people may be members of the central or local SASAC. In a more general sense, the function of the committee has also been questioned for its strong administrative nature, and its seeming inconsistency with a market economy with Chinese characteristics, exemplified via the composition of the committee. Zhang for instance has observed that courts have appointed government-organised liquidation committees instead of qualified insolvency practitioner firms in most reorganisation cases related to SOEs, and the courts seems to have full discretion when selecting government-organised liquidation groups as insolvency and liquidation administrators, irrespective of whether cases involve

¹⁰⁸ EBL 1986, Article 24.

¹⁰⁹ Art. 18, Appointment Regulations contains various circumstances in which a liquidation group can still be appointed, such as where the case is of public importance

¹¹⁰ ‘Regulations of the Supreme People’s Court on the Appointment of Administrators for Hearings on Cases of Enterprise Bankruptcy, Art. 18.

¹¹¹ See X. Wang, ‘Several Issues Concerning the Perfection of the System of Bankruptcy Administrators in China[論破產管理人制度完善的若幹問題]’ [2010] 9 *Legal Research* 14, 15.

¹¹² Zhang, *supra* note 105, 70–71.

SOEs or non-SOEs.¹¹³ In cases where a liquidation committee approach to governance is taken in relation to a zombie SOE, the case may be shaped by political and social considerations. This is particularly likely if the liquidation group is dominated by local government officers. For instance, the resettlement of employees and impacts on local communities are likely to be weighing concerns, given the impact that significant job losses would have on employees, individually and collectively, in the absence of a well-developed social security system. . Some zombie SOEs may rely heavily on the support and coordination of various government departments, and insolvency procedures involving these companies may generate problems such as how to distribute state-owned assets and resettle staff responsibly and effectively.¹¹⁴

It is possible that this liquidation committee approach is a transitional one, necessitated by the status of zombie SOEs. Their preservation, in our opinion, is in line with the recent government policy on eliminating zombie companies,¹¹⁵ a main principle of which is to maintain a sound policy and institutional environment for eliminating zombie SOEs.¹¹⁶ The liquidation committee may serve as an intermediate device until a more established selection system and more comprehensive roster of administrators has been established, supported by more experienced and qualified insolvency practitioners in China. Strengthening of the liquidation committees would also be desirable at this transitional stage. It is clear that corporate insolvency is technical in nature, based on laws that are lacking in detailed guidance, and liquidation committees are likely to lack relevant expertise. Such groups may be bolstered by the involvement of professionals such as lawyers to advise on the procedural steps required, the verification of claims and possible litigation such as avoidance actions. This would seem to be a desirable approach in all cases where a liquidation group takes control.

However, looking at the trajectory of future development, the appointment of liquidation committees may leave fewer opportunities for inexperienced insolvency practitioners to practice or grow their expertise. Courts may also miss out on opportunities to build a more established designation system out of the roster of administrators. As a result, the reform of China's insolvency law system may be undermined by the appointment of these committees to resolve cases involving zombie companies. Progressively, there is evidence of a consensus that liquidation committees organised by the government should be abolished.¹¹⁷ Already a more market-based approach is emerging in cases involving administrator appointments, since courts in the more economically advanced provinces such as Zhejiang, Sichuan

¹¹³ *Ibid.*

¹¹⁴ J. Gao, *Analysis on the Case of Economic Law 经济法案例解析精选* (Southwest University of Finance and Economics Press 2016) 110-111.

¹¹⁵ See National Development and Reform Commission, 'Notice on Further Doing a Good Job of "Zombie Enterprises" and Debt Disposal of De-capacity Enterprises 关于进一步做好“僵尸企业”及去产能企业债务处置工作的通知' (November 23rd 2018)

¹¹⁶ *Ibid.*, Principle 2.

¹¹⁷ Zhang, *supra* note 105, 72.

and Jiangsu, have moved away from consulting the local government prior to the acceptance of a case.¹¹⁸ In practice, even in a more market-oriented system it would be unrealistic to expect that state intervention can be eliminated entirely. There may be a remaining need for state intervention in cases where enterprises are socially important,¹¹⁹ and an approach based solely on the market could give rise to significant externalities. For example, both central and local governments in China still play a facilitative role in restructuring socially important zombie companies, including through negotiating with creditors, arranging the redeployment of workers, payments of wages and arranging funding. Therefore, an intermediate and hybrid approach may be developed in which insolvency courts will work cooperatively alongside government officials and experts.¹²⁰ In addition, a potentially exciting and innovative approach is the use of specialist experts in particular industries as trouble-shooters to reorganise struggling companies.

5.5 Case Study: The Steel Industry

Having outlined the paradoxical and inconsistent progress which has been made towards the eradication of zombie companies as well as the potential of developing insolvency systems, it will be useful to consider the employment of market-based approaches in one sector, as illustrations of how the problems of zombie companies can be tackled. Zombie companies are present primarily in the steel and coal industries.¹²¹ Taking the steel industry as an example, these companies emerged due to rapid economic growth which stimulated a large demand for steel while industrial output growth declined swiftly in 2011. As a result, steel prices rose and some declining companies in other industries rushed into the steel industry, intensifying overcapacity and further cutting down the profit rate in the industry.¹²² Uncompetitive yet socially important steel companies then became zombie companies supported by local governments in order to maintain social stability rather than allowing fair competition to lead to the market exit of these companies.¹²³

Recently these problems of overcapacity and loss-making zombie companies have been tackled under changing government policies that were noted previously. Government policy in relation to this sector was set out in a “Steel Industry

¹¹⁸ Steele *et al*, *supra* note 4, 681.

¹¹⁹ S. Azgad-Tromer, ‘Too Important to Fail: Bankruptcy Versus Bailout of Socially Important Non-Financial Institutions’ (2017) 7 *Harvard Business Law Review* 159.

¹²⁰ W. Du, ‘Ten Issues that Must be Grasped in the Current Bankruptcy Trial Work’ (4 April 2018, Beijing) *People’s Court Daily*.

¹²¹ For example, see Wang Xiaolong and Baosteel General Steel Special Steel Pipe Co., Ltd. *Labour Dispute Second Judgment Civil Judgment* 王晓龙与包钢通用钢铁特种钢管有限责任公司劳动争议二审 (2018) Nei 02 Min Zhong No.2745 内 02 民终 2745 号; Chen Wu and Wugang Group Hainan Co., Ltd. *Labour Dispute Second Trial* (2017) 陈与武钢集团海南有限责任公司劳动争议二审 (2017) Qiong 01 Minou No. 1570 琼 01 民终 1570 号.

¹²² M. Zhang, ‘Where do Zombies Lurk in China? Mostly in Steel and Real Estate, Report Finds’ *South China Morning Post* 30 July 2016.

¹²³ ‘Closing the Zombie Companies! The Central Government Is Concerned with Millions of Unemployment’, 31 December 2015, <http://www.pccpop.com/doc/1/1595/1595302.shtml>.

Adjustment Policy”, which has the objective of moving this sector towards a more market-based model,¹²⁴ following various attempts in earlier years. External relations have also placed pressures on the reform of the steel industry and the elimination of zombie companies.¹²⁵ A diversification of financing has also indicated that companies in this sector are no longer as sheltered as they once were. Formerly zombie companies were financed primarily by state-owned banks, and this shielded them from the market pressures that would normally lead to the opening of insolvency proceedings. However, increasing levels and forms of private finance have been obtained through bonds and the shadow financial system, including non-bank financial institutions such as trust companies.¹²⁶ This diversified finance has meant that failing companies have faced pressure from less sympathetic creditors,¹²⁷ and bond defaults may be the factor which will lead some zombie companies towards a market exit.

In practice, various market-based approaches have been seen in terms of the liquidation and restructuring of zombie companies in this sector. Examples of market-based responses have included the partial-privatisation of Dongbei Special Steel. The restructuring of this company, which was a serial defaulter, included a debt for equity swap, under which creditors gained a significant percentage of the shares in the enterprise, as well as a substantial share being acquired by a private investor.¹²⁸ A market-based restructuring approach was also seen in relation to the Chongqing Iron and Steel Co. Ltd., which at one time had been severely loss-making, and was restructured by an investment company specialising in the steel sector, which made investments and managerial changes resulting in the company being restored to profitability.¹²⁹ In contrast, for a zombie company in which the proportion of debt to equity was too high to conduct a debt for equity swap, or effect a restructuring, the company would more appropriately enter liquidation, such was the case of the Guangxi Nonferrous Metals Group in 2016.¹³⁰

¹²⁴ Although by setting targets for market dominance by a specific number of producers and specific market shares, it did seem that the market would be the determining factor.

¹²⁵ *US China Economic and Security Review Commission 2018 Annual Report*, 112–113.

¹²⁶ China’s Zombie State-Owned Enterprises Benefit from Surge in Debt-Equity Swaps, China Banking News, 22 Aug, 2017, <https://www.chinabankingnews.com/2017/08/22/chinas-zombie-state-owned-enterprises-benefit-surge-debt-equity-swaps/>.

¹²⁷ There had been expectations that the Shanghai Chaori Solar Energy Science and Technology bond default would lead to a more market-based approach. However, this company was ultimately able to repay bondholders in full. Today Online, ‘China’s leaders urged to allow more defaults among zombie firms’ 29 December 2014, <<https://www.todayonline.com/chinaindia/china/chinas-leaders-urged-allow-more-defaults-among-zombie-firms>>. Other bond defaults in other sectors have followed: *US China Economic and Security Review Commission 2018 Annual Report*, 94–95.

¹²⁸ See e.g. C. Yap, ‘China’s Zombie Companies Stay Alive Despite Defaults’ *Wall Street Journal* July 12, 2016.

¹²⁹ Y. Hong, ‘Governance to the Rescue’ <http://csj.hkics.org.hk/site/2018/11/14/governance-to-the-rescue/>; R. Parry and Y. Long, ‘China’s enterprise bankruptcy law, building an infrastructure towards a market-based approach’ (2020) 20 *Journal of Corporate Law Studies* 157.

¹³⁰ ‘Court in China Declares State-run Metals Firm Bankrupt’, *Reuters*, 20 Sep, 2016.

6. Conclusion

Zombie companies emerged in China for historical and social reasons, in particular as a result of earlier expansionary economic strategies. As businesses with poor performance, they complicate China's rising corporate debt problem.¹³¹ Being uncompetitive, unsustainably financed, insolvent and "stiff but deathless",¹³² a number of zombie companies remain in China. If they do not exit the market in a timely and legitimate manner, these companies may cause unfair and ineffective allocation of social resources, which will distort the market and accumulate financial risks,¹³³ as well as hampering the sustainable recovery of the economy from the shocks of the Covid-19 pandemic.

This article has aimed to evaluate the changing institutional environment in China in an attempt to facilitate a more enabling insolvency law scheme to deal with these difficulties. We have advocated a hybrid between market-oriented mechanisms and administrative measures as the viable approach. Our proposals not only focus on more effective insolvency mechanisms such as empowering creditors' meetings and committees, reducing the influence of administrative liquidation committees, and strengthening the administrator system, but also emphasise the establishment of a strong and efficient judicial environment through specialised courts. We also propose that the boundary between the government and the companies needs to be better defined.¹³⁴ Meanwhile, the tension between the exit policies with pre-set targets for the quantity of zombie companies and market nature for triggering the insolvency procedures should also be recognised by the government and policy makers.

Insolvency proceedings may be able to resolve the debt problems faced by inefficient zombie companies and restore their effective and sustainable operational capacity and profitability. We have critically investigated a few insolvency law related issues in order to facilitate a better objective and market-based legal environment to eliminate zombie companies. There are alternatives to liquidation but not all will be suitable in every case. Merging companies may create bigger and more problematic zombies, and another alternative of debt for equity swaps may trade zombie companies for zombie banks.¹³⁵

The closure or reorganisation of non-performing zombie companies can arguably only be achieved in China by relying on a hybrid approach that relies mainly on market-oriented measures, supplemented by government intervention to provide social services and an enabling environment for these measures. A market-based

¹³¹ W. Maliszewski, S. Arslanalp, J. Caparusso, J. Garrido, S. Guo, J.S. Kang, W.R. Lam, D. Law and W. Liao, 'Resolving China's Corporate Debt Problem' IMF Working Paper 16/203.

¹³² Jiang *et al*, *supra* note 46.

¹³³ Banerjee & Hofmann, *supra* note 10.

¹³⁴ J. Fang, G. Gozgor, C-K.M. Lau, W. Wu & C. Yan, 'Listed Zombie Firms and Top Executive Gender: Evidence from an Emerging Market' (2020) 62 *Pacific-Basin Finance Journal* 101357.

¹³⁵ F. He, 'Dealing with zombie enterprises' [2016] *East Asia Forum Quarterly* 3, 5.

approach is likely to be subject to significant path dependency factors such as a distinctive history of economic and social isolation, immature corporate and personal insolvency laws and poor enforcement, a developing juridical system, the important role played by SOEs, as well as the unique social challenges and economic model.

A need for development is also reflected in the government policies towards enterprise and personal insolvency.¹³⁶ Guidance by government agencies can play an important role. For example, the SPC promulgated a notice requiring courts to distinguish between companies that came under financial distress due to the pandemic shock and those that were already zombies prior to the pandemic, with the expectation that the latter should be liquidated.¹³⁷ Moreover, the insolvency law in China will further its unique mission as the characteristics of the socialist market economy have also left a strong imprint on the protection of the interests of stakeholders and promotion of social welfare, especially employees' interests.¹³⁸

The elimination of zombie companies should be seen as an economic and social development function rather than a political task and accordingly a balance needs to be struck between market-oriented mechanisms and administrative measures. Arguably, some government administrative interference is unavoidable and reflects deeply rooted views within China's political system, as well as China's judicial system, culture and corporate governance model which has both administrative and economic governance characteristics.¹³⁹ We perceive that government influence will continue to be necessarily exerted at various levels in insolvency procedures for disposal of zombie companies in China. However, we believe that a transformative approach is necessitated by the status of zombie companies and, led by an improved insolvency infrastructure, will be the preferred solution to address the existing social and economic problems brought by the zombie companies. It would also help minimise the risk of further zombification and enhance sustainable economic recovery in the wake of the Covid-19 pandemic.

¹³⁶ Progress so far has been mainly happening to judicial guidelines but see 深圳經濟特區個人破產條例 Shenzhen Special Economic Zone Personal Bankruptcy Regulations (promulgated by the Standing Committee of the Shenzhen Municipal People's Congress, Aug. 26, 2020, effective March 21, 2021). See further R. Parry, H. Zhang and J. Fu, 'Personal Insolvency in China: Necessities, Difficulties and Possibilities' (2021) 46 *Brooklyn Journal of International Law* (forthcoming).

¹³⁷ See 最高人民法院關於依法妥善審理涉新冠肺炎疫情民事案件若干問題的指導意見 Notice by the Supreme People's Court of Issuing the Guiding Opinions (Part II) on Several Issues of Properly Hearing Civil Cases concerning the COVID-19 Pandemic(2020).

¹³⁸ Zhao, *supra* note 68, 73-4.

¹³⁹ Keay & Zhao, *supra* note 5.