

## THE 2006 PRC ENTERPRISE BANKRUPTCY LAW: THE WAIT IS FINALLY OVER

The lengthy Chinese bankruptcy law reform process that began in 1994 ended on 26 August 2006, with the enactment of the PRC Enterprise Bankruptcy Law. This article discusses five controversial areas that were debated throughout the drafting process – the scope of the law, bankruptcy administration, corporate reorganisation, priorities and the protection of employee rights, and cross-border issues – and how they have been resolved in the new law. The article also discusses recent developments since the new law came into operation on 1 June 2007.

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<sup>1</sup> This article updates the author's discussion of Chinese insolvency law reform in "Drafting Bankruptcy Laws in Socialist Market Economies: Recent Developments in China and Vietnam" (2004) 18 *Columbia Journal of Asian Law* 93 ("Drafting Bankruptcy Laws in Socialist Market Economies"). It arises from the author's presentations on panels at six recent conferences: The 2006 PRC Enterprise Bankruptcy Law Panel, The 2006 PRC Enterprise Bankruptcy Law: A New Beginning? Symposium, Institute of Asian-Pacific Business Law ("IAPBL"), William S Richardson School of Law, University of Hawaii at Manoa & Asian Institute of International Financial Law ("AIIFL") University of Hong Kong Faculty of Law, Hong Kong, 25 March 2008 ("IAPBL-AIIFL 2006 PRC Enterprise Bankruptcy Law Symposium"); Panel Discussion on the New Bankruptcy Law – Cross-Border Issues Faced by Foreign Investment Enterprises, The 11th Beijing Economic Cooperation Symposium, Seminar on Beijing-Hong Kong Corporate Restructuring, Merger & Acquisition and Liquidation, Beijing, China, 6 November 2007 ("11th Beijing Economic Cooperation Symposium"); Restructuring & Investing Conference, Association of Insolvency & Restructuring Advisors ("AIRA"), Shanghai, China, 22 October 2007; Situational Investing in Undervalued Assets Panel, Entrepreneurialism, Risk Assessment, and Private Investment Symposium, IAPBL, William S Richardson School of Law, University of Hawaii at Manoa & AIIFL, University of Hong Kong Faculty of Law, Hong Kong, 18 October 2007; and Insolvency Reform in China Panel, International Bar Association ("IBA") Singapore 2007 Conference, Singapore, 16 October 2007 ("IBA Singapore 2007 Conference"); and Asian-Pacific Corporate Insolvency Law: Cross-Border and Comparative Perspectives – Inaugural Symposium, IAPBL, William S Richardson School of Law, University of Hawaii at Manoa, Halekulani Hotel, Honolulu, Hawaii, 10–11 April 2007 ("IAPBL Asian-Pacific Corporate Insolvency Law Symposium").

## I. Introduction

1 For well over a decade, observers of China's insolvency system awaited word of the enactment of a new bankruptcy law. On 27 August 2006, the Chinese Government finally enacted the Enterprise Bankruptcy Law ("2006 PRC Enterprise Bankruptcy Law"), which came into operation on 1 June 2007.<sup>2</sup> The drafting process commenced in March 1994 when the Financial and Economic Committee of the 8th National People's Congress ("NPC") set up a Working Group for Drafting the New Chinese Bankruptcy Law ("Bankruptcy Law Drafting Working Group"). The road to enactment progressed in a series of fits and starts, with several interruptions and delays to enable the various constituents to reach agreement on some of the more controversial recommendations that emerged during the drafting process. But the drafting process finally concluded in 2006, and the new law has now been in operation for roughly one year.

2 An earlier piece that the author co-authored discussed the 2002 draft Chinese bankruptcy law in detail<sup>3</sup> and another highlighted seven areas of the proposals in that draft.<sup>4</sup> A more recent piece offered an update of the law reform process from 2002–2004 and considered five of the more controversial areas that were debated during the drafting process – the scope of the law, bankruptcy administration, corporate reorganisation, priorities and the protection of employee rights, and cross-border issues.<sup>5</sup> This article returns to these five areas and discusses how these issues were resolved in the 2006 PRC Enterprise Bankruptcy Law. It will also comment on recent developments since the new law came into operation on 1 June 2007.

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2 The 2006 Law of the People's Republic of China on Enterprise Bankruptcy Law, adopted at the 23rd meeting of the Standing Committee of the Tenth National People's Congress on 27 August 2006, and promulgated on that date, and effective as of 1 June 2007 (reprinted by the China Legal Publishing House) ("2006 PRC Enterprise Bankruptcy Law"). A translation by the Bankruptcy Law and Restructuring Research Center of China University of Politics and Law under the supervision of Professor Li Shuguang may also be found at (2008) 17(1) *International Insolvency Review* 33.

3 Charles D Booth, John Lees, Henry Pitney & Charles Tabb, "Comments and Suggestions on the Draft Bankruptcy Law of the People's Republic of China", a report prepared for the International Republican Institute (27 April 2002) in connection with an insolvency law reform project advising the Finance and Economic Committee of the National People's Congress of the People's Republic of China.

4 Charles D Booth & Wendy Chiu, "A Comparison of the Draft Bankruptcy Laws of the People's Republic of China and Vietnam", forthcoming in *Insolvency Risk Management: Standards and Strategies for the Next Decade* (World Bank).

5 Charles D Booth, "Drafting Bankruptcy Laws in Socialist Market Economies", *supra* n 1.

3 Part II of this article offers a brief overview of the pre-law reform legal landscape and the weaknesses therein that gave rise to the bankruptcy law reform process in China. Part III puts the Chinese bankruptcy law reform process in a broader context of legal and administrative reforms in China, and Part IV updates the five areas noted above.

## II. The pre-law reform legal landscape<sup>6</sup>

4 Given China's currently booming economy, it is easy to forget that not all that long ago the Chinese economy was a centrally-planned socialist economy comprising large state-owned enterprises ("SOEs") that were funded through government-directed "policy loans" by the state-owned commercial banks ("SOCBs"), with little concern given to the ultimate ability of the SOEs to repay these loans.

5 Once China decided to make the transition from a centrally-planned economy to a market-based economy, it was necessary to enact a bankruptcy law to deal with those inefficient, insolvent SOEs that were unable to repay their debts. China enacted the Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) on 2 December 1986, and it came into operation on 1 October 1988 ("1986 Chinese Bankruptcy Law").<sup>7</sup> This law applied only to SOEs. On 9 April 1991, the PRC Civil Procedure Law was approved,<sup>8</sup> with Chapter XIX applying to the bankruptcy of non-SOE enterprises with legal person status. Thus, by 1991, China had a bifurcated insolvency system, with one law for SOEs and another for non-SOE enterprises with legal person status.

6 Since these laws were quite short – the 1986 Chinese Bankruptcy Law included only 43 articles, and Chapter XIX of the PRC Civil Procedure Law, only eight – they lacked sufficient detail, and there were many gaps and omissions in coverage. There were also some inconsistencies between the bankruptcy procedures for SOEs and those for non-SOE legal personal enterprises. The People's Supreme Court issued a series of judicial interpretations to address these problems. For example, the Opinion on Questions Concerning the PRC Enterprise

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6 For a more detailed discussion of this pre-law reform backdrop, see *id.*, at pp 97–100, 102.

7 Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation) (2 December 1986) ("1986 Chinese Bankruptcy Law"), translated in Legislative Affairs Commission of the Standing Commission of the National People's Congress (compilation), *Laws of the People's Republic of China (Civil and Commercial Laws 289–297)* (1983–1986).

8 PRC Civil Procedure Law, promulgated by Order No 44 of the President of the PRC on 9 April 1991 and effective as of that date.

Insolvency Law (Trial Implementation) issued on 7 November 1991 (“1991 PRC Supreme People’s Court Opinion”)<sup>9</sup> interpreted the 1986 Chinese Bankruptcy Law, and with 76 articles was almost twice as long as the law it was interpreting. Following in 1992 was the PRC Supreme People’s Court’s Application of the PRC Civil Litigation Law Several Issues Opinion for non-SOE enterprise legal persons (with 14 articles).<sup>10</sup> One of the significant issues that arose at this stage was whether certain provisions in the 1986 Chinese Bankruptcy Law for SOEs were also applicable to non-SOE bankruptcies.<sup>11</sup>

7 In addition to the 1986 Chinese Bankruptcy Law and Chapter XIX of the PRC Civil Procedure Law, completing the national insolvency framework were a few other provisions in the PRC Company Law<sup>12</sup> and in the PRC Liquidation Procedures of Foreign Investment Enterprises<sup>13</sup> regarding solvent liquidation procedures that specified when, in the course of administering solvent liquidations, if it appeared that the debtor was in fact insolvent, the case should be fed into the insolvency law provisions in the PRC Civil Procedure Law. Article 189 of the PRC Company Law supplemented the provisions of the PRC Civil Procedure Law in bankruptcies involving PRC companies.

8 The final part of the pre-insolvency law legal landscape was at the local level. Some local governments had enacted their own local bankruptcy regulations, procedures and rules, for example, the Shenzhen SEZ Enterprise Bankruptcy Regulations, enacted by the Standing Committee of the Shenzhen People’s Congress on 10 November 1993.<sup>14</sup>

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9 Ref No 2500/91.0.07. Printed in the Research Office of the Supreme People’s Court (compilation), *The Assemblage of Judicial Interpretations of the Supreme People’s Court of the PRC* (“1991 PRC Supreme People’s Court Opinion”).

10 Application of the PRC Civil Litigation Law Several Issues Opinion (7 November 1991) <[http://www.lawbook.com.cn/law/law\\_view.asp?id=8106](http://www.lawbook.com.cn/law/law_view.asp?id=8106)>.

11 Gordon C Chang, “Bankruptcy Law in China: too much or too little?” (June/July 1999) 13(5) *China L & Prac* 22, 22–23. This issue remained contentious until 30 July 2002, when the Supreme People’s Court issued its bankruptcy law interpretation entitled *Several Issues Concerning the Trial of Enterprise Bankruptcy Cases* (“2002 PRC Supreme People’s Court Provisions”).

12 Chapter VIII of the PRC Company Law of 1993 entitled *Bankruptcy, Dissolution and Liquidation of Companies* for companies (limited liability companies and companies limited by shares) formed under the PRC Company Law (adopted on 29 December 1993, as amended on 25 December 1999 and 28 August 2004) (“PRC Company Law”).

13 PRC Liquidation Procedures of Foreign Investment Enterprises adopted by the Ministry of Foreign Trade and Economic Cooperation (9 July 1996).

14 These regulations replaced the Shenzhen Bankruptcy Provisions on Foreign Related Companies that were enacted in 1986 before the SOE Bankruptcy Law was even promulgated. See Xianchu Zhang & Charles D Booth, “Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience” (2001) 15 *Colum J Asian L* 1 (“Zhang & Booth, ‘Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience’”)  
(*cont’d on the next page*)

9 Relatively few bankruptcy cases were commenced in the first few years after the enactment of the new laws. From 1989 until 1993, the courts accepted a total of only 1,153 cases: 98 in 1989, 32 in 1990, 117 in 1991, 428 in 1992, and 478 in 1993.<sup>15</sup> Of these cases, the number of successful reorganisations was close to zero.<sup>16</sup> Significantly, the number of bankruptcy cases did not accurately reflect the dire straits of many SOEs. This was but a small fraction of the poorly performing enterprises in China – it has been estimated that in pre-1996 China there were over eight million enterprises and commercial households,<sup>17</sup> and that close to, if not a majority, of these enterprises were operating at a loss. For example, a national survey conducted in 1997 of 14,923 large and mid-sized SOEs found that 40.5% were losing money.<sup>18</sup> The 1986 Chinese Bankruptcy Law and the other bankruptcy laws and provisions were intended to create market discipline, but by 1994 it was clear that more needed to be done.

### III. Putting the bankruptcy law reform process in a broader context<sup>19</sup>

10 In March 1994, the Chinese Government formed the Bankruptcy Law Drafting Working Group, which completed a first draft in 1995. After a hiatus that was caused in part by a concern about the

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Market Economy”). For a discussion of procedures in Beijing for the solvent liquidation of foreign investment enterprises (“FIEs”) called the Liquidation Provisions of Foreign Investment Enterprises, adopted by the Standing Committee of the Beijing People’s Congress on 14 August 1993, see Xianchu Zhang & Charles D Booth, “Beijing’s Initiative on Cross-Border Insolvency: Reflections on a Recent Visit of Hong Kong Professionals to Beijing” (2002) 10 Am Bankr Inst L Rev 29 (“Beijing’s Initiative on Cross-Border Insolvency”).

15 According to the Statistics of the PRC Supreme People’s Court in March 2001, cited in Wang Weiguo & Charles D Booth, “Study on Alternative Approaches for Debt Restructuring of Enterprises in China” in *World Bank Report for the State Economy and Trade Commission of China, 2002* (Wang) at p 12 (“Wang & Booth”). The statistics of the PRC Supreme People’s Court are not uniformly accepted. According to the statistics of the Beijing Siyuan Merger and Bankruptcy Consultancy, as reported by Cao Siyuan in the “Implementation and Revision of the Bankruptcy System in China”, a paper presented at INSOL China 2002, held in Beijing, China, (9–11 October 2002), there were 710 cases in 1993.

16 Wang Weiguo, *Bankruptcy Law* at p 220 (in Chinese, 1999).

17 Zhang & Booth, “Chinese Bankruptcy Law in an Emerging Market Economy”, *supra* n 14, at p 2 footnote 4.

18 *Ibid*, at pp 2–3, citing Qiu Xiaohua & Others, “Dazhong Xing Guoyou Qiye Yunying Xingshi Burong Leguan” (The Operational Conditions of Large and Mid-Sized State Owned Enterprises Are Not Bright) 2 *Zhongguo Guoli* (State Conditions) 21 (in Chinese, 1999).

19 This section incorporates parts of Booth, “Drafting Bankruptcy Laws in Socialist Market Economies”, *supra* n 1, at pp 99–102 and Charles D Booth, Zhang Xian Chu & Wendy Chiu, “The People’s Republic of China” in *Collier International Business Insolvency Guide* (2006) ch 18, para 18.04[3]–[4] at pp 18–28.

high level of unemployment quite likely to arise from subjecting many SOEs to the bankruptcy law,<sup>20</sup> the drafting process resumed in 1998. Further drafts of the law were released for comment, including drafts in 2000, 2001, 2002, June 2004 and October 2004. By 2004, most of the provisions in the draft law had been agreed – roughly two-thirds of the 2002 draft was incorporated into the June 2004 draft – but disagreements remained in regard to several important issues that were not resolved until the promulgation of the 2006 PRC Enterprise Bankruptcy Law.

11 The bankruptcy legal reform process was an important development, but it cannot be viewed in a vacuum. The law reform efforts were but one part of the Chinese Government's arsenal of reforms and remedies to address the historical overhang of problems from the centrally-planned market economy, including SOEs' high level of non-performing loans ("NPLs"), the resulting weak balance sheets of the main SOCBs, and the complicated issues relating to the resettling of workers of bankrupted or reorganised SOEs. The Chinese Government pursued these various reforms and remedies simultaneously.

12 The most significant remedy was the use of bankruptcy policy decrees. Starting in 1994, the State Council and other administrative organs issued a series of decrees to facilitate debt restructuring on a large scale through merger and acquisition and bankruptcy under the Capital Structure Optimization Program ("CSOP").<sup>21</sup> On 25 October 1994, the State Council issued the notice entitled Proposal for Carrying Out State-Owned Enterprise Bankruptcy Law in Some Cities ("1994 PRC Notice"),<sup>22</sup> which addressed problems involving the resettlement of workers of state-owned industrial enterprises ("SIEs") made bankrupt in 18 pilot cities, including Shanghai. This notice provided special treatment for the resettlement of workers – resettlement rights were entitled to the first priority from the selling of an SIE's land use rights by auction or tender. The 1994 PRC Notice was followed by the Notice on Certain Issues on Trial Implementation of Mergers and Insolvency on State-Owned Enterprises, which was issued by the former State Economy and Trade Commission ("SETC") and the People's Bank of China on 25 July 1996,<sup>23</sup> and increased the number of trial cities to 56. On 2 March 1997, the State Council issued a further Supplementary

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20 Charles D Booth, "Chinese Insolvency Law: Developing an Insolvency Infrastructure" (March 2001) IPBA J 13 at 13 ("Chinese Insolvency Law") (noting comments of Zhu Shao Ping, Chair of the Working Group for Drafting the New Chinese Bankruptcy Law, Fiscal and Economic committee under the Standing of the PRC National People's Congress ("Bankruptcy Law Drafting Working Group").

21 See Wang & Booth, *supra* n 15, at pp 8–16 (Wang).

22 Document No 59 ("1994 PRC Notice").

23 Document No 492, 1996.

Notice concerning the Problems Pertaining to the Trial Implementation of State-Owned Enterprise Merger and Bankruptcy and Re-employment in Certain Cities (“1997 PRC Notice”), which increased the number of trial cities to 111.<sup>24</sup> Section 2 of the 1997 PRC Notice provided for the formulation of a Mergers and Bankruptcies of Enterprises Program to be established under the co-ordination of the former SETC, whereby in various trial cities, a list of enterprises would be drawn up for merger, bankruptcy and rescue. Article 5 of the 1997 decree extended the special protection for workers. It clarified that the resettlement rights of workers would have priority over secured creditors and would initially be met by the land use right (whether or not it was secured). Where this proved insufficient, the claims would be met by the disposal of non-secured and secured property, and where even that was insufficient, the People’s Government of the same level as the SOE would be responsible for bearing the costs. Lastly, protection would also extend to certain pension and medical benefits of workers employed by SOEs without insurance policies to cover such entitlements.

13 These decrees were to apply to the selected SOEs whether or not the 1986 Chinese Bankruptcy Law applied. The “special treatment” for workers’ resettlement and other defined rights providing certain workers’ claims with priority over secured creditors were inconsistent with the traditional priority scheme in the 1986 Chinese Bankruptcy Law.

14 The Government’s policy decrees were not the only governmental effort to facilitate the restructuring of the SOEs. Additional administrative out-of-court restructuring efforts were pursued. For example, in September 1999 at the 4th Session of the 15th Party Congress, the Decision of Several Significant Issues on the Reform and Development of State-Owned Enterprises was made, which included measures for the banks to increase their bad-debt write-off of funds to support the merger and bankruptcy of the large and medium-sized SOEs.<sup>25</sup> Other measures included converting the debt of SOEs into equity, thereby converting the SOCBs (the major creditors of the SOEs) into shareholders.<sup>26</sup>

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24 Document No 10, 1997 (“1997 PRC Notice”).

25 Wang & Booth, *supra* n 15, at p 11 (Wang).

26 See Guanghua Yu & Minkang Gu, “Enterprise Bankruptcy Law” in *Laws Affecting Business Transactions in the PRC* (2001) ch 15 at pp 550–551.

15 Significant steps were also taken to improve the operation of the SOCBs and the PRC Commercial Bank Law, promulgated in 2005, provided that commercial banks, with the consent of the financial regulatory authority, could be made bankrupt by a People's Court.<sup>27</sup> Also, in 1999, four asset management companies ("AMCs") were established to deal with the high level of NPLs of the four main SOCBs,<sup>28</sup> and others have been established since then.<sup>29</sup> A further effort to improve the situation of SOEs and the SOCBs was the restructuring procedure devised by the former SETC, which came to be known as the "Changchun Approach".<sup>30</sup>

16 As these various approaches were pursued for many years – and the enactment of a new bankruptcy law was still many years away – in 2002, the Supreme People's Court issued its most comprehensive interpretation of the old bankruptcy laws, which included some of the ideas that were developing in the law reform process.<sup>31</sup>

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27 PRC Commercial Bank Law Art 71 (promulgated by the President of the PRC on 10 May 1995 and effective as of 1 July 1995, as amended on 27 December 2003). A similar provision for insurance companies was included in the PRC Insurance Law Art 86 (promulgated by the President of the PRC on 30 June 1995 and effective as of 1 October 1995, as amended on 27 October 2000). See Part IV.A(2) of this article for a discussion of these provisions.

28 China Xinda Asset Management Company ("Cinda") for the Construction Bank of China (the first to be established in April 1999), China Huarong Asset Management Corporation for the Industrial and Commercial Bank of China, Dongfang Asset Management Company ("Oriental") for the Bank of China, and the China Great Wall Asset Management Company for the Agricultural Bank of China. See [http://www.gii.co.jp/english/ae7393\\_asset\\_manage\\_china.html](http://www.gii.co.jp/english/ae7393_asset_manage_china.html). The AMCs also played an important role in the promulgation of debt-equity swaps. See Wang & Booth, *supra* n 15, at p 17 (Wang).

29 See, *eg*, the Guangdong Guangye Asset Management Company. See [http://www.chinaonline.com/estore/financial/AA030-75\\_PR.htm](http://www.chinaonline.com/estore/financial/AA030-75_PR.htm).

30 See Wang & Booth, *supra* n 15.

31 See *supra* n 11.



#### IV. An overview of key areas debated in the law reform process and their resolution in the 2006 PRC Enterprise Bankruptcy Law<sup>32</sup>

##### A. *The scope of the new law*

17 A key goal of the insolvency law reform was to harmonise the various insolvency processes in China and to enact a unified law that would replace the old patchwork of insolvency legislation. This goal has been achieved to a great extent. Article 2 of the 2006 PRC Enterprise Bankruptcy Law provides that the new bankruptcy law applies to all enterprises with legal person status.<sup>33</sup> Thus, the insolvency regime has been dramatically simplified – the new bankruptcy law replaces the 1986 Chinese Bankruptcy Law and the insolvency provisions in the PRC Civil Procedure Law and the PRC Company Law. Article 136 of the 2006 PRC Enterprise Bankruptcy Law repeals the old 1986 Chinese Bankruptcy Law as of 1 June 2007. The revised PRC Civil Procedure Law (“PRC Civil Procedure Law (Revised)”), which came into operation on 1 April 2008<sup>34</sup> does not include the insolvency provisions that were in

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32 The historical material in this section is adapted from Booth, “Drafting Bankruptcy Laws in Socialist Market Economies”, *supra* n 1, at pp 105–108, 111, 112, 114–120, 125–132, 138–141, 142–144. For further discussion of the 2006 PRC Enterprise Bankruptcy Law, see Steven T Kargman, “Solving the Insolvency Puzzle: China’s new bankruptcy law could bring the country’s legal framework closer to international norms – if it is implemented effectively” *China Business Review* (September–October 2007); Jingxia Shi, “Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China’s Transition to a Market Economy” (2008) 16 *Norton Journal of Bankruptcy Law and Practice* 645 (“Twelve Years to Sharpen One Sword”); Lijie Qi, “The Corporate Reorganization Regime under China’s New Enterprise Bankruptcy Law” (2008) 17(1) *International Insolvency Review* 13; Xianchu Zhang, “New Bankruptcy Regime in China: A Critical Analysis of the New Bankruptcy Law of the PRC” paper presented at IAPBL Asian-Pacific Corporate Insolvency Law Symposium, *supra* n 1; Zhang Xian Chu, “Developments Since the Adoption of the New Enterprise Bankruptcy Law of the PRC” (working draft), at p 5, IAPBL-AIIFL 2006 PRC Enterprise Bankruptcy Law Symposium, *supra* n 1. For charts comparing provisions in the new Chinese bankruptcy law with their US counterparts, see Michael Gerber, “The Bankruptcy Laws of the United States and the People’s Republic of China – A Comparison of Some Key Elements” prepared for the 2007 Brooklyn Law School/Loyola Law School Summer Program in Beijing and the ABA Section of International Law 2007 Spring Meeting and also distributed at the IAPBL-AIIFL 2006 PRC Enterprise Bankruptcy Law Symposium, *supra* n 1; Michael D Good, “A ‘Great Leap Forward’? Or a ‘Leap in the Dark’? What Happens When the New Chinese Enterprise Insolvency Law Meets US Courts” (2008) 5 *International Corporate Rescue* 25 at 31–42.

33 This would include most FIEs, with the limited exception of those co-operative joint ventures (“CJVs”) or wholly foreign-owned enterprises (“WFOEs”) that are non-legal person enterprises.

34 PRC Civil Procedure Law (Revised), promulgated on 28 October 2007 and effective as of 1 April 2008.

Chapter XIX of the PRC Civil Procedure Law. Lastly, Art 191 of the amended PRC Company Law (“PRC Company Law (Amended)”), which came into operation on 1 January 2006,<sup>35</sup> provides that if a company is declared bankrupt in accordance with the law, it shall be subject to bankruptcy liquidation in accordance with the new 2006 PRC Enterprise Bankruptcy Law.<sup>36</sup>

18 Although Art 2 of the new law clearly improves upon the old legal framework, its coverage is not universal. Several questions arose during the law reform process as to the appropriate scope of the new law. These debates arose around four issues:

- (a) Should the new law apply to all SOEs?
- (b) Should the new law apply to banks, insurance companies and securities companies?
- (c) Should the new law apply to non-legal persons, including partnerships and sole proprietorships?
- (d) Should the new law extend beyond business-related enterprises and apply to consumers?

(1) *Should the law apply to all SOEs?*

19 Historically, in socialist China, the SOEs were the backbone of the economy providing the majority of goods and services, and providing employment for millions of workers. SOE workers had what has been referred to as an “iron rice bowl” with jobs for life and a broad array of guaranteed benefits, including housing, education and health care. The enactment of the 1986 Chinese Bankruptcy Law was the beginning of the end of the broad-based iron rice bowl social policy. It would soon become clear that SOEs subjected to bankruptcy or reorganisation would not be able to retain all of their employees and would no longer be able provide a lifetime of additional benefits. Instead, one of the goals of the bankruptcy process would be to provide

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35 PRC Company Law (Amended), promulgated by Order No 42 of the President of the PRC on 27 October 2005, and effective as of 1 January 2006.

36 The old Art 189 of the PRC Company Law, which supplemented the provisions of the PRC Civil Procedure Law under the old bankruptcy law regime, has been deleted. Article 188 of the PRC Company Law (Amended) provides that where in the course of administering solvent liquidations it appears that the company is insolvent, an application shall be made to the People’s Court for a declaration of insolvency in accordance with the law. Article 188 further provides that after the People’s Court declares the company insolvent, the company’s liquidation committee shall turn the liquidation matters over to the People’s Court. Thus, the new Art 188 continues the channelling process that was included in the old Art 196 of the PRC Company Law.

a minimum level of social benefits, including the “resettlement” and retraining of many of its workers.

20 In practice, however, the 1986 law was more of a paper tiger than a realistic threat and the Government realised that it needed to be improved. As noted above, there was generally a low level of cases under China’s bankruptcy laws from their enactment until the commencement of the drafting process and by 1994 the Chinese Government had decided that a new bankruptcy law was needed to assist with the problems plaguing China’s SOEs. Thus, at the outset of the law reform process, there was a strong connection between the new bankruptcy law and the desire to assist SOEs. However, the Chinese Government came to fear that a strict application of bankruptcy laws to all insolvent SOEs would very likely trigger two other sets of problems: (a) high unemployment that could result in social unrest, and (b) a knock-on effect on the banking sector leading to the bankruptcy of many state-owned banks.<sup>37</sup> The first factor was the main reason for the suspension of the bankruptcy law drafting process in 1995. As noted in Part III of this article, because of the magnitude of these problems, concurrently with the bankruptcy law drafting process, the Chinese Government pursued other reforms to more immediately address the dire state of the SOEs.

21 Given the variety of approaches that the Chinese Government was using to address the problems confronting SOEs and the high level of government control over the SOE reform process generally, it is not surprising that an emerging area of disagreement was whether all SOEs should be subjected to the new bankruptcy regime. By 2000, a split emerged within the Bankruptcy Law Drafting Working Group. At a conference organised by the Asian Institute of International Financial Law at the University of Hong Kong in November 2000, there was a heated discussion among working group members as to whether the new law should apply to all SOEs or whether there should be a carve-out for some of the older SOEs.<sup>38</sup> This latter view was incorporated into the 2001 and 2002 draft bankruptcy laws. Article 3 of the 2002 draft law provided that the State Council was authorised to stipulate regulations concerning the special issues of bankruptcies conducted by SOEs established before 1994, when the PRC Company Law took effect.<sup>39</sup> It thus appeared from the 2002 draft that only SOEs established after that

37 See Zhang & Booth, “Chinese Bankruptcy Law in an Emerging Market Economy”, *supra* n 14, at 3.

38 Symposium, Chinese Insolvency Law: The Need to Develop An Effective Insolvency Infrastructure, organised by AIIFL at the University of Hong Kong, 17–18 November 2000. See also Booth, “Chinese Insolvency Law”, *supra* n 20, at 15.

39 Earlier language to this effect appeared in Art 168 of the 2001 draft Chinese bankruptcy law.

date would be subject to the new law and that the older, larger and more inefficient SOEs would be exempt from its application.<sup>40</sup>

22 This exemption for the older SOEs did not appear in the October 2004 draft of the Chinese bankruptcy law, but the effect appeared to be the same. Article 148 of the October 2004 draft provided that before the enactment of the new bankruptcy law, the special matter of the insolvency of SOEs within a certain scope and within certain deadlines previously set by the State Council should be addressed by regulations prescribed by the State Council. Shortly after the October 2004 draft was circulated, further details emerged – the broader proposal was to allow certain SOEs to go bankrupt under relevant regulations issued by the State Council. This exemption was to apply to the largest SOEs. The State-Owned Assets Supervision and Administration Commission (“SASAC”) of the State Council estimated that roughly 2,000 SOEs might take advantage of this “administrative closure”.<sup>41</sup>

23 There was a difference of opinion as to how long this period would last. The majority view was that it would extend for two to three years and that, thereafter, the new law would handle all SOE bankruptcies.<sup>42</sup> One firm suggested at the time that the exemption period might last for three to five years.<sup>43</sup> This latter view has proven to be correct as the projections for a two to three-year period were overly optimistic. The approach of the October 2004 draft has been adopted in the 2006 PRC Enterprise Bankruptcy Law. Article 133 of the new law provides as follows:

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

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40 Although it remained unclear whether the older SOEs would be subject to new regulations or remain subject to the 1986 Chinese Bankruptcy Law. Article 162 of the 2002 draft Chinese bankruptcy law provided for the abolition of the 1986 law upon the enactment of the new law, but at a workshop in which the author participated that was organised by the Finance and Economic Committee of the National People’s Congress of the People’s Republic of China and held in Beijing, China, in April 2002, members of the bankruptcy law drafting committee noted that perhaps the old law would continue to apply to these old SOEs until new regulations were drafted.

41 Lan Xinhen, *Outdated Bankruptcy Law Upgraded* (2004) <[http://www.bjreview.com.cn/200430/Business-200430\(B\).html](http://www.bjreview.com.cn/200430/Business-200430(B).html)>.

42 *Ibid.*

43 PricewaterhouseCoopers, *China’s new bankruptcy law: The start of something big?* (2004) <[http://www.pwchk.com/home/printeng/cn\\_bankruptcy\\_law\\_oct2004.html](http://www.pwchk.com/home/printeng/cn_bankruptcy_law_oct2004.html)>.

24 The State Council issued regulations stating that June 2008 would be the final deadline for handling the administrative bankruptcies of these SOEs. By the end of 2007, SASAC had handled the bankruptcy of 2,116 SOEs and anticipated that it would complete the “last patch of policy bankruptcy” of the final 698 SOE bankruptcies by the end of June 2008.<sup>44</sup> These numbers are 814 – or 41% – higher than SASAC’s projections made just four years earlier. It now appears unlikely that SASAC will even be able to meet this deadline, and the deadline will have to be extended yet again. It seems that whenever SASAC is “almost” done, there are always a few more hundred SOEs in need of administrative closure. It is most likely that policy bankruptcies will continue – at a minimum – for many more years to come.

25 The irony of the situation is that well over a decade has passed – closer to 15 years – since China began reforming its bankruptcy laws, and although the new Chinese bankruptcy law was initially intended to deal with serious SOE problems, this has not been the result. By the time the law came into operation, the majority of SOEs in need of assistance had already been dealt with through the government-mandated administrative closure procedures; and although the new law is now being applied, the Government prefers to deal with the remaining SOEs on its list through the SASAC procedures rather than pursuant to the new law. Early ambitions have given way to a pragmatic administrative solution.

26 On its face, the new law applies to both SOEs and non-SOE legal person enterprises. However, since the Government continues to pursue its parallel administrative closure track for certain SOEs, the reality is that the new law only applies to some SOEs. Not until the period for administrative closure expires will the new law truly harmonise the bankruptcy treatment of all SOEs and thus of SOEs and non-SOE legal person enterprises.

(2) *Should the new law apply to banks, insurance companies, and securities companies?*

27 As discussed above, until recently, many of China’s largest commercial banks were in very bad financial shape, and the Government took many steps to address the situation with the transfer of NPLs to AMCs and other administrative efforts. Unfortunately, the legal infrastructure to handle the bankruptcy of these entities has been almost non-existent. The PRC Commercial Bank Law, enacted in 1995, included Art 71 providing that a commercial bank not paying its debts may, with the consent of the People’s Bank of China, be declared

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44 Zhang Xian Chu, “Developments Since the Adoption of the New Enterprise Bankruptcy Law of the PRC”, *supra* n 32, at p 5.

bankrupt by a People's Court.<sup>45</sup> In 2003, when the China Banking Regulatory Commission ("CBRC") was established, the PRC Commercial Bank Law was amended to require the consent of the CBRC for a commercial bank to be declared bankrupt.<sup>46</sup> A similar procedure is included in Art 86 of the PRC Insurance Law for insurance companies, requiring the consent of the China Insurance Regulatory Commission.<sup>47</sup> Both of these provisions provide for the appointment of a liquidation team. Article 71 of the PRC Commercial Bank Law also includes a paragraph setting out that the "payment of the principal of savings deposits of individuals and interest thereon shall be given a priority after the liquidation expenses, the wages owed to the employees and labour insurance premiums have been paid". Article 88 of the PRC Insurance Law provides for a similar priority for the indemnification or payment of insurance money. Article 87 of the PRC Insurance Law also provides for the transfer of the debtor company's life insurance contracts and reserve funds to other insurance companies.

28 There have been some high profile collapses of large financial entities in China over the last decade – including the massive bankruptcy of the Guangdong International Trust and Investment Corporation in 1999 – that demonstrate the need for the enactment of a legal regime to handle the bankruptcy of financial institutions.

29 During the law reform process, there has been a long-running debate about whether financial institutions should be covered by the new law or subject to separate procedures specifically designed for financial institutions. The 2002 draft explicitly excluded commercial banks from the scope of coverage of the bankruptcy law.<sup>48</sup> There was a view among some that the new bankruptcy law should apply to commercial banks and insurance companies, but that securities companies and trust companies would not be mentioned explicitly for fear that they would seek special treatment.<sup>49</sup> This view, however, did not carry the day and the general exclusion was carried over into the June and October 2004 drafts. Article 149 of the October 2004 draft provided that the insolvency of banks, insurance companies, and other financial organisations shall be governed by implementation regulations based on the new bankruptcy law and related laws to be issued by the State Council.

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45 See *supra* n 27.

46 *Ibid.*

47 *Ibid.*

48 2002 draft Chinese bankruptcy law Art 160.

49 The securities firms in China are arguably in a more precarious situation than the Chinese banks. See Report on the 2004 Symposium on Building the Financial System of the 21st Century: An Agenda for China and the United States, held in Beijing, China (11–13 June 2004) at p 21.

30 The approach adopted in Art 134 of the 2006 PRC Enterprise Bankruptcy Law modified the approach of the October 2004 draft. Like the October 2004 draft, it provides that where a financial institution goes bankrupt, the State Council may formulate implementing measures in accordance with the provisions of the new bankruptcy law and other laws. However, unlike the October 2004 draft, Art 134 also provides that the financial regulatory authority under the State Council may apply to the People's Court for the reorganisation or bankruptcy of a financial institution where the financial institution – including a commercial bank, securities company and insurance company – is unable to pay its debts under Art 2 of the new bankruptcy law.<sup>50</sup>

31 Article 134 thus continues the approach of the October 2004 draft by providing that the State Council may formulate “implementing measures”.<sup>51</sup> However, unlike the October 2004 draft, it also empowers the financial regulatory authority under the State Council to apply for the reorganisation or bankruptcy of a financial institution. There is no general consensus as to the effect of this provision on the ability of debtors or creditors to file petitions. On its face, the provision appears to restrict this power to the government financial regulatory authority and to deny creditors and debtors the right to petition.<sup>52</sup> However, one commentator has noted that the position of Zhu Shao Ping, the Chair of the Bankruptcy Law Drafting Working Group, is that the financial regulatory authority’s “special right” of pre-petition approval does not

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50 2006 PRC Enterprise Bankruptcy Law Art 134 also provides that where the financial regulatory authority under the State Council, in accordance with law, takes such measures as takeover or custody of a financial institution as a major operation risk, it may apply to the People's Court for a stay of civil or enforcement proceedings against the financial institution.

51 Some implementing measures in the form of administrative regulations have already recently been enacted. See Zhang, “Developments Since the Adoption of the New Enterprise Bankruptcy Law of the PRC” *supra* n 32, at p 2 (noting that the bankruptcy of foreign capital banks’ operational entities are to be governed by the relevant Chinese laws (The Administrative Regulation of Foreign Capital Banks Art 60 (15 November 2006)); that the bankruptcy of a futures trading company requires the approval of the China Securities Regulatory Commission (The Administrative Regulations of Futures Trading Art 19 (16 March 2007)); and that bankruptcy petitions against financial leasing companies, automobile finance companies, or trust companies require the prior approval of the CBRC (Measures of Financial Leasing Company Administration Art 19 (16 March 2007)), Measures of Automobile Financing Company Administration Art 16 (3 February 2008) and Measures of Trust Company Administration Art 14 (28 March 2007)).

52 See Shi, “Twelve Years to Sharpen One Sword”, *supra* n 32, at 660. As noted above, under both the PRC Commercial Bank Law and the PRC Insurance Law, the consent of the relevant regulatory commission is necessary for the making of a bankruptcy declaration.

deprive financial institutions themselves or their creditors of the right to petition.<sup>53</sup>

32 It now appears that these open issues regarding the insolvency of financial institutions may soon be answered. In February 2008, the CBRC announced that the legislative process for developing insolvency procedures for financial institutions has begun and that a special ordinance on the bankruptcy of banking and financial institutions to supplement the new bankruptcy law is being considered to create a “market-oriented bail-out mechanism”.<sup>54</sup> According to industry analysts, the new procedures will try to “minimise the aftermath of bankruptcy of banks and financial institutions” while simultaneously providing the “maximum protection to the interests of depositors, creditors and taxpayers”.<sup>55</sup>

(3) *Should the law apply only to non-legal persons including partnerships and sole proprietors?*

33 Under the old bankruptcy regime, SOEs were subjected to the 1986 Chinese Bankruptcy Law and non-SOE legal person enterprises to the PRC Civil Procedure Law. Article 206 of the latter explicitly excluded individual businesses (eg, sole proprietorships) and partnerships formed by private individuals. Within the Bankruptcy Law Drafting Working Group, there was some support for expanding the scope of the business entities to be subject to the new law and the 2002 draft Chinese bankruptcy law adopted this approach. Article 3 of the 2002 draft included partnership enterprises and their partners, individual proprietorship enterprises, and other profit-making organisations established in accordance with the law. However, the October 2004 draft returned to the position in the old PRC Civil Procedure Law. Article 2 of the October 2004 draft limited application of the new law to debtors that are legal person enterprises and the revised Art 147 provided that the bankruptcy of partnerships and sole proprietorships shall be dealt with under other related laws.

34 This was one of the open issues being debated into 2006 and the new law expands on the approach of the October 1994 draft. Article 135 of the 2006 PRC Enterprise Bankruptcy Law provides that where other laws include insolvent liquidation procedures of non-legal person entities, the procedures set forth in the 2006 PRC Enterprise Bankruptcy

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53 Zhang, “Developments Since the Adoption of the New Enterprise Bankruptcy Law of the PRC”, *supra* n 32, at p 9 (citing Zhu Shao Ping, “Several Issues Concerning Bankruptcy of Financial Institutions” (2007) 9 China Finance 20 (in Chinese)).

54 “China legislates on bankruptcy of banks” *China Daily* (9 February 2008) <[http://www.chinadaily.com.cn/china/2008-02/09/content\\_6446300.htm](http://www.chinadaily.com.cn/china/2008-02/09/content_6446300.htm)>.

55 *Ibid.*



Law shall apply *mutatis mutandis*. The Amended Partnership Enterprise Law of the PRC (amended in 2006) (“Amended PRC Partnership Enterprise Law”),<sup>56</sup> which came into operation on the same day as the new bankruptcy law, provides for the insolvent liquidation of partnerships. Article 92 of the Amended PRC Partnership Enterprise Law provides as follows:

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

35      This provision enables a partnership’s creditors to petition for the bankruptcy of the partnership. In conjunction with Art 135 of the 2006 PRC Enterprise Bankruptcy Law, once a bankruptcy case is commenced, an administrator may be appointed, avoidance powers may be exercised and the property of the debtor may be protected. Notably, this provision gives the right to petition only to creditors and not to the partnership itself. In addition, the provision explicitly states that the individual partners remain liable for the company’s debts.

36      The interaction of Art 92 of the Amended PRC Partnership Enterprise Law and Art 135 of the 2006 PRC Enterprise Bankruptcy Law subjects partnerships to the new bankruptcy law without enabling the individual partners to use the new law. It is good to see that creditors may resort to filing a petition against a partnership, but it is unfortunate that the right to petition was not extended to partnerships themselves. Similarly, it would have been better if individual partners and sole proprietorships were also eligible for bankruptcy relief. Subjecting individual business owners and partners to the new bankruptcy law would provide the courts with experience in addressing some of the issues that arise in individual bankruptcies, such as those involving automatic discharge and exempt property.

(4)      *Should the new law apply to consumers?*

37      When China’s bankruptcy law for SOEs was enacted in 1986 and for non-SOEs five years later, the focus of the laws was solely on enterprises; consumers were outside the scope of these laws. By the time the drafting process commenced, there was some interest in extending

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56 Partnership Enterprise Law of the PRC (adopted at the 24th session of the Standing Committee of the 8th National People’s Congress on 23 February 1997, as amended at the 23rd session of the Standing Committee of the 10th National People’s Congress of the PRC on 27 August 2006; amendments came into operation on 1 June 2007 (“Amended PRC Partnership Enterprise Law”).

the new laws to consumers. Over the last decade, a middle class has emerged in many parts of China, leading to increased consumer financing and credit card spending.<sup>57</sup> There was some support within the Bankruptcy Law Drafting Working Group for extending the new bankruptcy law to consumers, but this was clearly the minority view. Since individual partners and sole proprietorships remain outside the scope of the 2006 PRC Enterprise Bankruptcy Law, it should not be surprising that consumers remain outside the scope of the new law.

38 With the continuing expansion of consumer credit in China, it is only a matter of time before China will have to reconsider this issue.<sup>58</sup> If there is a slowdown in the property market or in the economy generally, or another serious outbreak of SARS or bird flu, pressure will grow quickly for such reform. Experience in Asia has demonstrated that it is better to enact bankruptcy laws before they are perceived to be needed rather than in times of crisis.

### **B. Bankruptcy administration**

39 Under the old Chinese bankruptcy law, there was not a single individual – eg, a trustee or an administrator – in charge of administering the assets of the case. Rather, the court established a liquidation committee comprising members chosen from the superior department in charge of the SOE, liquidation-related intermediary organisations, relevant government departments (including financial departments, administrations for industry and commerce, planning commissions, etc) and professionals, including lawyers and accountants.<sup>59</sup> In practice, professionals were rarely appointed to the

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57 For example, during the SARS crisis in Beijing in 2005, car sales boomed; in April 2003, 50% of the sales were on instalment. See “Auto Market to Maintain Fast Growth” Xinhua News Agency (30 May 2003) <<http://www.china.org.cn/english/2003/May/65827.htm>>.

58 For a comprehensive analysis of the relationship between consumer credit and personal bankruptcy law reform in China, Xian-Chu Zhang, “Development of Consumer Credit in China and Concerns about the Underlying Legal Infrastructure” in *Consumer Bankruptcy in Global Perspective* (Johanna Niemi-Kiesilainen, Iain Ramsay & William C Whitford eds) (2003) ch 5.

59 1986 Chinese Bankruptcy Law Art 48. See also Art 23 (for SOEs); PRC Civil Procedure Law Art 201 (for non-SOEs); PRC Company Law Art 189 (for companies). The relevant government departments often designated members of the committee. Li Shuguang, “The Significance Brought by the Drafting of the New Bankruptcy Law to China’s Credit Culture and Credit Institutions”, at p 13, paper presented at the Forum on Asian Insolvency Reform 2004: Insolvency Systems and Risk Management in Asia, held in New Delhi, India, 3–5 November 2004, sponsored by the World Bank, the Asian Development Bank, and the OECD (“Forum on Asian Insolvency Reform 2004”).

committee, and, in the bankruptcy of non-SOEs, the liquidation committee usually played a minor role.<sup>60</sup>

40 A further problem under the old law was the gap in control after the acceptance of the case – the liquidation committee was not appointed when the court accepted the case, but rather within 15 days of the date the court made the adjudication order.<sup>61</sup> During the gap period, which could be lengthy, there often was no one in charge to prevent existing management from misappropriating the debtor's assets.<sup>62</sup> This problem was not addressed until Art 18 of the 2002 PRC Supreme People's Court Provisions provided that during the gap period, the court upon accepting a bankruptcy case had the power to appoint "an enterprise management committee".

41 A major innovation that emerged during the drafting process to address these serious infirmities in the Chinese procedures was the introduction of a new functionary in the bankruptcy procedure called an "administrator", who would take control of the debtor's assets and exercise a broad range of administrative responsibilities. This innovation appeared as a section in a chapter in the 2002 draft<sup>63</sup> and as Chapter III in both the October 2004 draft and in the new 2006 PRC Enterprise Bankruptcy Law.

42 The administrator (or administrators) shall be appointed by the court from the day the case is accepted.<sup>64</sup> The administrator is to be appointed from the relevant government department or institution or from law firms, accounting firms, bankruptcy liquidation firms, or other public intermediary bodies.<sup>65</sup> Based on the debtor's actual situation, the People's Court may, after consulting with the relevant public intermediary body, appoint a person from the body who possesses professional knowledge in a related field and who has obtained the qualifications for practice to serve as an administrator.<sup>66</sup> The thrust of the provision is to appoint professionals who are qualified to hold the position of administrator. Article 24 of the new law sets out criteria that disqualify an individual or institution from appointment, including

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60 Li, *supra* n 59, at p 13.

61 Article 47 of the 2002 PRC Supreme People's Court Provisions (regarding the 1986 Chinese Bankruptcy Law).

62 Wang Weiguo, "Administrator in New Bankruptcy Law of China", paper presented at the Forum on Asian Insolvency Reform 2004, *supra* n 59.

63 See 2002 Draft Chinese Bankruptcy Law Arts 27–32.

64 2006 PRC Enterprise Bankruptcy Law Art 13. Predecessor provisions may be found in the October 2004 draft Chinese bankruptcy law Art 19; 2002 draft Chinese bankruptcy law Art 16.

65 2006 PRC Enterprise Bankruptcy Law Art 24. Predecessor provisions may be found in the October 2004 draft Art 21; 2002 draft Art 27.

66 *Ibid.*

having a prior criminal record, having a professional licence revoked, or being an interested party in the case. It also includes a catch-all provision for other circumstances in which the People's Court deems that it is inappropriate for the individual or entity to be appointed.<sup>67</sup>

43 Article 22 of the 2006 PRC Enterprise Bankruptcy Law provides that the Supreme People's Court shall formulate measures for designating administrators and setting their remuneration. Once the 2006 PRC Enterprise Bankruptcy Law was adopted, the General Office of the Standing Committee of the National People's Congress officially requested the Supreme People's Court to issue detailed implementing rules.<sup>68</sup>

44 The Supreme Court issued these rules in April 2007 – before the 2006 PRC Enterprise Bankruptcy Law came into operation – in the form of the PRC Supreme People's Court Provisions on Designation of Bankruptcy Administrators (“2007 PRC Supreme People's Court Bankruptcy Administrator Designation Provisions”)<sup>69</sup> and Provisions on Remuneration of Bankruptcy Administrators (“2007 PRC Supreme People's Court Bankruptcy Administrator Remuneration Provisions”).<sup>70</sup> Article 2 of the 2007 PRC Supreme People's Court Bankruptcy Administrator Designation Provisions provides that a Higher People's Court should prepare a roster of administrators within its jurisdiction, taking into account the number of law firms, accounting firms, bankruptcy liquidation firms, and other social intermediary agencies, number of full-time practitioners, and number of enterprise bankruptcy cases. Article 2 also provides that Higher People's Courts not in one of the four municipalities directly under the Central Government – Beijing, Tianjin, Shanghai, and Chongqing – shall indicate the

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67 The predecessor provisions may be found in the October 2004 draft Art 22 and 2002 draft Art 27.

68 See Zhang, “Developments Since the Adoption of the New Enterprise Bankruptcy Law of the PRC”, *supra* n 32, at p 3 (citing the Supreme People's Court website <<http://www.coiurt.gov.cn/news/bulletin/release/2006091130022.htm>> (in Chinese)).

69 Announcement of the Supreme People's Court of the People's Republic of China, Provisions of the Supreme People's Court on the Designation of Administrators during the Trial of Enterprise Bankruptcy Cases, adopted at the 1422nd judicial meeting of the Supreme People's Court on 4 April 2007, and came into force as of 1 June 2007 (also cited as Judicial Interpretation No 8 [2007] of the PRC Supreme People's Court) (“2007 PRC Supreme People's Court Bankruptcy Administrator Designation Provisions”).

70 Announcement of the Supreme People's Court of the People's Republic of China, Provisions of the Supreme People's Court on Determining the Administrator's Remuneration during the Trial of Enterprise Bankruptcy Cases (adopted at the 1422nd judicial meeting of the Judicial Committee of the Supreme People's Court on 4 April 2007, and came into force as of 1 June 2007) (also cited as Judicial Interpretation No 9 [2007] of the PRC Supreme People's Court) (“2007 PRC Supreme People's Court Bankruptcy Administrator Remuneration Provisions”).

Intermediate People's Court within whose jurisdiction are the designated members of the roster.

45 The 2007 PRC Supreme People's Court Bankruptcy Administrator Designation Provisions set forth guidelines for application and announcement procedures, and lists of information for applicants to submit. Article 10 provides that each People's Court preparing a roster shall form a review committee of at least seven members to vet the applications. Article 10 also sets forth a list of criteria to be used in the selection process, but the actual selection process differs from jurisdiction to jurisdiction. For example, Beijing adopted a 100-point scheme for choosing applicants with the following weighting:

- (a) Turnover of business – 20 points
- (b) Size of the firm by head count and number of qualified professionals – 20 points
- (c) Practical experience in handling bankruptcy cases – 30 points
- (d) Number of relevant liquidation reports – 15 points
- (e) Number of relevant published articles – 5 points
- (f) Professional liability insurance cover – 10 points<sup>71</sup>

46 Grant Thornton conducted a survey on the announcements made by the People's Courts in four municipalities, 22 provinces, and five autonomous regions, which included the jurisdiction of 31 Higher People's Courts. The survey found that as of 11 September 2007, nine jurisdictions had announced their final panels.<sup>72</sup> In Guangdong and Hubei, the Intermediate People's Courts had announced their preliminary or final panels although their corresponding Higher People's Courts had not yet made any announcements.<sup>73</sup> Of the respondents in their survey, 40–60% of the panel members were law firms, 20–40% were accounting firms and 5–20% were bankruptcy liquidation firms.<sup>74</sup> Interestingly, although there was much debate in the years leading up to the enactment of the new bankruptcy law about whether the Chinese Government would allow foreigners to serve as administrators, in practice this has not proved to be a problem. The

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71 Alan Tang & Pauline Au, "China's enterprise bankruptcy law: The central government's new regulations on bankruptcy administrators" HKICPA A Plus 48 (November 2007) <[http://www.hkicpa.org.hk/APLUS/0711/p48\\_50.pdf](http://www.hkicpa.org.hk/APLUS/0711/p48_50.pdf)>.

72 *Id.*, at 50.

73 *Ibid.*

74 *Ibid.*

Grant Thornton study found that the final panel in Beijing included four international accounting firms.<sup>75</sup>

47 Article 11 provides that after finalising their preliminary rosters, the People's Courts shall announce their proposals and give the public time to object. It was noted during the drafting process that "bankruptcy administration will emerge as a new profession in China".<sup>76</sup> The goal is for administrators to be professionals with the necessary expertise and background to perform the responsibilities and duties required of them and for the firms represented on the list to have the personnel and resources to perform their functions satisfactorily. The administrator is to be a disinterested and neutral party. Eventually, it is anticipated that there will be a special licence required for serving as an insolvency administrator and that a unified examination will be established.<sup>77</sup> This will most likely be many years away. In the interim, it is important for China to establish a training and education programme for potential administrators and members of the panels.

48 The general practice that has emerged since the enactment of the 2006 PRC Enterprise Bankruptcy Law is for administrators to be appointed in a rotation system.<sup>78</sup> Although insolvency practitioners are generally positive regarding the improvements that the new administrator system brings to China's insolvency procedures, several criticisms of the application of the new procedures have emerged.<sup>79</sup> First of all, since there are large numbers of administrators on some panels, the wait between cases can be substantial. Secondly, the rotation system does not take into account that a given firm or practitioner might well have special expertise of relevance for specific cases. Thirdly, the scoring system in some places, such as Beijing, does not rate actual experience in insolvency cases as high as some practitioners believe it should be treated. And lastly, many of the registers of administrators are incomplete because the relevant People's Courts are awaiting updates from the provinces and because the lists are not amended as often as necessary to reflect changes arising from the death, retirement or disqualification of panel members.

49 As a general rule, the 2007 PRC Supreme People's Court Bankruptcy Administrator Remuneration Provisions provide for remuneration on a scale dependent on the total value of the assets

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75 *Ibid.*

76 Wang, *supra* n 62, at p 4.

77 *Id.*, at p 3.

78 For example, during discussions at the IAPBL-AIIFL 2006 PRC Enterprise Bankruptcy Law Symposium, *supra* n 1; 11th Beijing Economic Cooperation Symposium, *supra* n 1.

79 *Ibid.*

distributed in the bankruptcy cases. In short, the remuneration schedule is as follows:

Table: The remuneration provisions under the 2006 Enterprise Bankruptcy Law<sup>80</sup>

Total value of distributable property (yuan) <sup>81</sup>	Administrator's remuneration (% of total value of distributable property)
< 1 million	12% or less
> 1 million to 5 million	10% or less
> 5 million to 10 million	8% or less
> 10 million to 50 million	6% or less
> 50 million to 100 million	3% or less
> 100 million to 500 million	1% or less
> 500 million	0.5% or less

50 However, Art 2 of the 2007 PRC Supreme People's Court Bankruptcy Administrator Remuneration Provisions also provides that where the People's Court sees fit, it may adjust an administrator's remuneration within a range of 30% from the rates set out above. In addition, the People's Court may make other adjustments:

... depending on the complexity of the bankruptcy case, the administrator's performance (such as diligence, contribution to a business's revival, risks borne and responsibilities undertaken), the local residents' disposable income, and the price level of the debtor's location.<sup>82</sup>

51 For those cases in which the creditors' meeting objects to the administrator's remuneration, the 2007 PRC Supreme People's Court

80 2007 PRC Supreme People's Court Bankruptcy Administrator Remuneration Provisions Art 2, and may be found at Tang & Au, *supra* n 71, at 50, Table 2.

81 Excluding the assets of secured creditors. Where the administrator deals with these assets as well, he may charge the secured creditor a fee and if the secured creditor disagrees, the People's Court should resolve the matter. The 2007 Supreme People's Court Bankruptcy Administrator Remuneration Provisions Arts 2 and 13; Tang & Au, *supra* n 71, at 50.

82 Tang & Au, *supra* n 71, at 50.

Bankruptcy Administrator Remuneration Provisions set out the guidelines for the parties to resolve their differences.<sup>83</sup> Article 28 of the 2006 PRC Enterprise Bankruptcy Law also provides that the creditors' meeting may file objections regarding remuneration with the People's Court.

52 The administrator will play a major role in the new bankruptcy procedure with a broad range of responsibilities. Given the breadth and scope of his responsibilities, he will be able to hire staff, with the permission of the People's Court.<sup>84</sup> Article 25 sets out a broad list of administrative duties or functions that the administrator shall perform:<sup>85</sup>

- (1) taking over all of the debtor's property, books of account, documents, seals, and other data;
- (2) investigating into the debtor's property status and making a report thereon;
- (3) making decisions on the internal management affairs of the debtor;
- (4) determining the daily expenses and other necessary expenses for the debtor;
- (5) deciding whether the debtor shall continue to operate the business before the convention of the first creditors' meeting;
- (6) administering and disposing of the debtor's property;
- (7) participating in litigation, arbitration, or other legal proceedings on behalf of the debtor;
- (8) calling for the convening of the creditors' meeting; and
- (9) performing other duties that the court thinks shall be exercised by the administrator.

53 In addition to these functions set out in Chapter III, there are many other functions to be exercised by the administrator that are set out in other chapters of the draft law. These range from seeking application of the avoidance powers to raising objections to creditors' claims to playing an integral role in the reorganisation. If a reorganisation is attempted, the administrator is intended to play the leading role, unless the debtor chooses to retain control of the business –

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83 2007 PRC Supreme People's Court Bankruptcy Administrator Remuneration Provisions Art 7.

84 2006 PRC Enterprise Bankruptcy Law Art 28. Predecessor provisions may be found at October 2004 draft Chinese bankruptcy Law Art 26.

85 Article 23 was the predecessor provision in the October 2004 draft. There are some differences between the October 2004 draft and the final version, but they appear to be relatively minor. There were also some differences between Art 23 of the October 2004 and Art 29 of the 2002 draft.



under a modified debtor-in-possession approach – in which case the administrator will supervise the debtor.<sup>86</sup>

54 Throughout the drafting process, one of the most contentious issues regarding the administrator involved who should have the power of appointment. Article 16 of the 2002 draft provided that the People's Court would designate an administrator when accepting an application for bankruptcy, but Art 56(2) of the 2002 draft provided that when the case was underway, the creditors' meeting had the power to select, appoint and replace the administrator. This procedure was modified in the October 2004 draft by Art 19, which provided that the administrator shall be appointed by the court and that where the creditors' meeting thinks that the administrator cannot perform his duty fairly or is not competent, it may apply to the court to dismiss the administrator and appoint another one. The approach of Art 19 has been continued in Art 22 of the 2006 PRC Enterprise Bankruptcy Law. Article 22 provides that where the creditors' meeting is of the view that the administrator is not competent to perform his duties or has failed to perform his duties legally or impartially, the creditors' meeting may apply to the People's Court for the replacement of the administrator. Some members of the Bankruptcy Law Drafting Working Group argued for the administrator to be a "representative of the creditors", but ultimately the committee opted for the administrator serving as a "legal organ" independent of the creditors.<sup>87</sup>

55 Another controversial issue in the drafting process involved the supervision of the administrator. The 2002 draft Chinese bankruptcy law established an office called the "supervisor"<sup>88</sup> and one of the weaknesses of the 2002 draft was its lack of clarity as to the lines of demarcation among the supervisors, the People's Court and the creditors' meeting in supervising the administrator.<sup>89</sup> The October 2004 draft made significant improvements in this area, including abolishing the office of the supervisor and establishing a creditors' committee in its place. These improvements have been retained in the 2006 PRC Enterprise Bankruptcy Law. As did Art 62 of the October 2004 draft, Art 67 of the new bankruptcy law provides that the creditors' meeting may select up to nine members, who then need to be affirmed by the court. Members may include creditors or their representatives, and must include at least one worker or workers' representative. Under the new regime, the creditors' committee is intended to play an actual role in the process.<sup>90</sup> Article 68 of the 2006 PRC Enterprise Bankruptcy Law

86 See discussion in Part IV.C of this article.

87 Wang, *supra* n 62, at p 2.

88 2002 draft Chinese bankruptcy Law, Chapter V, Art 2.

89 See Booth & Chiu, *supra* n 4.

90 Wang, *supra* n 62, at p 3.

provides that the creditors' committee shall supervise the management and handling of the debtor's property and is entitled to request the administrator to make explanations or to supply relevant documents.<sup>91</sup> The committee may seek rulings by the People's Court where an administrator violates the bankruptcy law and refuses to accept supervision, as well as propose to convene the creditors' meeting or exercise other functions and powers authorised by the creditors' meeting. Article 69 of the 2006 PRC Enterprise Bankruptcy Law requires the administrator to report in a timely fashion on ten major activities to the creditors' committee. These activities include the following: transferring the ownership of real property; transferring property rights including mineral exploration, mining, intellectual property and other property rights; transferring all of the company's stock or business operations; taking out a loan; creating a security interest in property; transferring claims or a negotiable instrument; performing a bilateral contract; abandoning property; retrieving secured property; and performing other acts for disposing of property that have a significant effect on the creditors' interests.<sup>92</sup> If the administrator wants to undertake an activity specified in Art 69 before the establishment of the creditors' committee, he must promptly make a report to the People's Court. This Article gives more freedom to the administrator. The predecessor Art 64 of the 2004 October draft required the administrator to first seek the permission of the People's Court.

56 The overall success or failure of the new Chinese bankruptcy procedure will in great part depend on the performance of the administrators. The movement from government control of the liquidation committee to the professionalising of the administration position is an important development in the new procedures, as is the possibility for the creditors' committee to actively participate in the process. As noted above, there is some concern about the efficiency of the rotation system currently being adopted in several provinces, as well as about the weighting of factors for appointment to the panels. Some of these concerns might abate over time if an examination and licensing system is established.

### C. *Corporate rehabilitation*

57 Corporate reorganisation was possible under both the 1986 Chinese Bankruptcy Law and the PRC Civil Procedure Law – but more in theory than in practice. The number of cases involving corporate rescue in China under the old laws was close to zero.<sup>93</sup> One of the goals

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91 The predecessor provision in the October 2004 draft was Art 63.

92 The predecessor provision in the October 2004 draft, Art 64, specified 12 areas.

93 See *supra* n 16.

of the law reform process was to enact procedures that could be used for corporate rehabilitation.

58 The old Chinese bankruptcy law included few corporate rescue provisions. Part 4 of the 2002 PRC Supreme People's Court Provisions (Arts 25–30) and Pt IV of the 1986 Chinese Bankruptcy Law (Arts 17–22) included provisions regarding conciliation (also called reconciliation, mediation, settlement, composition or compromise) and reorganisation and there was one provision (Art 202) in the PRC Civil Procedure Law. Articles 33 and 34 of the 1991 PRC Supreme People's Court Opinion clarified the differences between conciliation and reorganisation. Article 34 provided that a draft conciliation agreement submitted to the creditors must set out the sources of capital for repayment of debt and the length of repayment. Article 33 provided that a reorganisation plan must include the following information: an analysis of the reasons for the enterprise having reached the edge of insolvency, a plan for the adjustment or establishment of a new management group for the enterprise, feasibility-concerning measures and reforms to be taken for the improvement of business management and measures to be taken for changes in production, methods of reducing losses and increasing profits, the term of the reorganisation (not to exceed two years) and objectives. In short, conciliation focused on the agreement between a debtor and its creditors regarding a payment scheme while reorganisation focused on how to improve the future economic situation of the debtor.<sup>94</sup>

59 Under the old law, there were restrictions as to which parties could commence the conciliation and reorganisation, as well as to which entities could use the procedures. For example, reorganisation was only available to SOEs and only in cases in which a creditor filed the bankruptcy petition. In such cases, where the SOE had a superior department in charge, only the government department was permitted to apply for reorganisation.<sup>95</sup> Where the SOE did not have a superior department in charge, the SOE's shareholders' meeting was permitted to pass a resolution and apply for reorganisation.<sup>96</sup>

60 Pursuant to Art 18 of the 1986 Chinese Bankruptcy Law, the reorganisation of an SOE always involved conciliation and after the making of a reorganisation application, the SOE was required to submit a conciliation agreement to the creditors' meeting. The 1986 Chinese Bankruptcy Law was silent as to whether conciliation was permitted for SOEs in cases not involving reorganisation. Conciliation was applicable

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94 See Yu & Gu, *supra* n 26, at p 537.

95 1986 Chinese Bankruptcy Law Art 17; 2002 PRC Supreme People's Court Provisions Art 28.

96 2002 PRC Supreme People's Court Provisions Art 28.

to non-SOEs and Art 25 of the 2002 PRC Supreme People's Court Provisions arguably extended the use of conciliation to SOEs in cases not involving reorganisation. An application for conciliation could be made by the debtor, but not the creditors. In addition, the People's Court was empowered to propose a settlement to the parties in the course of trying a bankruptcy case.<sup>97</sup>

61 The insolvency reform process emphasised the importance of corporate rescue. In the 2002 and October 2004 drafts, the reorganisation and conciliation chapters appeared before the liquidation chapter, and this organisation has been retained in the 2006 PRC Enterprise Bankruptcy Law, with Chapter VIII applying to reorganisation, Chapter IX to conciliation, and Chapter X to liquidation.

62 Among the most significant changes to the corporate rescue process are that both debtors and creditors are permitted to apply for reorganisation and that the process may be used for both SOEs and non-SOEs.<sup>98</sup> No longer will reorganisation be a procedure limited to SOEs to be used at the discretion of the Government (or of the shareholders in the absence of a superior department in charge). Another important change is that the parties may commence the insolvency procedure with the filing of a reorganisation petition, unlike the procedure under the 1986 law, which required that a bankruptcy petition first be filed, to be followed by an application for reorganisation after the bankruptcy case had been accepted.<sup>99</sup> Under the new law, in cases in which a creditor has petitioned for the bankruptcy of a debtor, the debtor itself or the shareholders holding more than 10% of the debtor's registered capital may apply for the reorganisation of the debtor after the People's Court has accepted the application and before a bankruptcy declaration has been made.<sup>100</sup>

63 The conciliation procedure has been retained, and, as under the old law, only the debtor is empowered to commence the procedure.<sup>101</sup> Under the new law, as under the October 2004 draft, the commencement of a reorganisation does not trigger a formal conciliation procedure. However, the reorganisation plan incorporates

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97 2002 PRC Supreme People's Court Provisions Art 25.

98 2006 PRC Enterprise Bankruptcy Law Art 70.

99 1986 Chinese Bankruptcy Law Art 17; 2002 PRC Supreme People's Court Provisions Art 28.

100 Article 70. Predecessor provisions may be found in the October 2004 draft Art 65 (also requiring the support of more than more than 10% of the registered capital) and in the 2002 draft Art 66 (requiring more than a third of the registered capital).

101 2006 PRC Enterprise Bankruptcy Law Art 95. A predecessor provision may be found in the October 2004 draft Art 93.

the factors that were included in the conciliation agreement under the 1986 Chinese Bankruptcy Law.

64 The period from when the People's Court decides to reorganise the debtor until the date that the court approves the reorganisation plan or terminates the reorganisation procedure is called the protective period of reorganisation or the reorganisation period.<sup>102</sup> One of the novel reforms in the new Chinese bankruptcy law is the hybrid approach towards the administration of the debtor's assets during this period. Many countries – such as the US – opt for a debtor-in-possession approach – pursuant to which there is a presumption that the debtor will remain in possession and administer the assets for the benefit of its creditors. Other countries – such as Commonwealth jurisdictions – opt for the appointment of an independent, neutral insolvency professional to take control. The new Chinese bankruptcy law combines these two approaches under a hybrid approach, pursuant to which the debtor may apply to the People's Court for approval to administer its assets and business affairs by itself under the supervision of the administrator.<sup>103</sup> Where approval is granted by the court, an administrator who has taken control of the debtor's property and business affairs is required to hand over control of the property and business affairs to the debtor. From that day forward, the debtor shall exercise the administrator's functions and powers.<sup>104</sup>

65 During the protective period, secured creditors are stayed from seeking repossession of their collateral, but they are allowed to seek exemption from the stay in cases in which their collateral may be damaged or its value decreased dramatically.<sup>105</sup> During the protective period, to assist the debtor in continuing its business operation, the debtor is permitted to borrow money and to grant security for such loans.<sup>106</sup> Predecessor provisions in the draft laws also permitted this, but the statutory language was more restrictive.<sup>107</sup>

66 The administrator or debtor – whichever is administering the debtor's property – is responsible for drafting the plan of

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102 2006 PRC Enterprise Bankruptcy Law Art 72. Predecessor provisions may be found in the October 2004 draft Art 68; 2002 draft Art 68.

103 2006 PRC Enterprise Bankruptcy Law Art 73. A predecessor provision may be found in the October 2004 draft Art 69.

104 2006 PRC Enterprise Bankruptcy Law Art 73

105 2006 PRC Enterprise Bankruptcy Law Art 75. Predecessor provisions may be found in the October 2004 draft Art 71; 2002 draft Art 71. Secured creditors are not subject to a stay in bankruptcy or conciliation.

106 2006 PRC Enterprise Bankruptcy Law Art 75.

107 October 2004 draft Art 72; 2002 draft Art 72.

reorganisation.<sup>108</sup> The draft plan must be submitted within six months of the making of the reorganisation order, subject to extension by the People's Court – at the request of the debtor or the administrator and for just cause – for an additional three months.<sup>109</sup> Article 81 of the 2006 PRC Enterprise Bankruptcy Law<sup>110</sup> provides that the plan must contain the following:

- (1) the management or business plan of the reorganized enterprise;
- (2) the classification of the debts;
- (3) the plan for the adjustment of the debts;
- (4) the repayment plan for the debts;
- (5) the time limits for the implementation of the reorganization plan;
- (6) the time limits for the supervision over the implementation of the reorganization plan; and
- (7) other plans that are conducive to the reorganization of the enterprise.

67 Debts in the plan are classified in one of four categories: secured debts, workers' claims, tax debts or ordinary unsecured debts.<sup>111</sup> Article 84 provides that the People's Court shall convene the creditors' meeting to vote on the plan within 30 days of receiving the draft plan and that the debtor or the administrator shall explain the draft plan to the creditors' meeting and answer creditors' questions.<sup>112</sup>

68 The creditors shall vote on the plan in the four groups noted above. Pursuant to Art 84 of the 2006 PRC Enterprise Bankruptcy Law, approval of the plan requires a majority in number of the creditors in each group present at the meeting and more than two-thirds of the settled amount of the debts of the group.<sup>113</sup> Pursuant to Art 86, the plan

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108 2006 PRC Enterprise Bankruptcy Law Art 80. Predecessor provisions may be found in the October 2004 draft Art 78; 2002 draft Art 78.

109 2006 PRC Enterprise Bankruptcy Law Art 79. A predecessor provision may be found in the October 2004 draft Art 77; *compare with* 2002 Draft Chinese Bankruptcy Law Art 81 (plan must be submitted to court within period set by People's Court).

110 Predecessor provisions may be found in the October 2004 draft Art 79; 2002 draft Art 79.

111 2006 Enterprise Bankruptcy Law Art 82. Predecessor provisions may be found at October 2004 draft Art 80; 2002 draft Art 80.

112 Predecessor provisions may be found in the October 2004 draft Art 81; 2002 draft Art 82.

113 Predecessor provisions may be found in the October 2004 draft Art 83; 2002 draft Art 84.

is adopted where all of the groups pass the plan.<sup>114</sup> Article 86 further provides that a court order is necessary for final approval and that the court is required to make a determination that the plan conforms to the provisions of the bankruptcy law.<sup>115</sup> Article 87 of the new law sets out procedures for situations in which the plan does not gain the approval of all of the groups, including holding a second vote and, in the remaining absence of agreement, giving the debtor or the administrator the right to apply to the court for approval of the plan over the objection of the group(s) that voted against the plan, based on the application of further criteria (including a limited “cramdown” power).<sup>116</sup> Pursuant to Art 88, where the reorganisation plan fails to be adopted by creditors and approved by the People’s Court, or having been adopted by the creditors the approval criteria is not satisfied, the People’s Court shall terminate the reorganisation procedure and declare the debtor bankrupt.<sup>117</sup>

69 Pursuant to Art 92 of the new law, when the People’s Court makes the order approving the plan, the plan is binding on the debtor and all creditors with debts established before the People’s Court accepted the bankruptcy case.<sup>118</sup> Articles 89 and 90 provide that the debtor is responsible for the implementation of the reorganisation plan, subject to supervision by the administrator.<sup>119</sup> Article 93 provides that where the debtor is unable to, or refuses to, implement the reorganisation plan, at the request of the administrator or the interested parties, the People’s Court shall make an order terminating the

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114 Predecessor provisions may be found in the October 2004 draft Art 84; 2002 draft Art 84.

115 Earlier drafts of the law required the court to make this determination before convening the meeting of creditors: October 2004 draft Art 81; 2002 draft Art 82.

116 Predecessor provisions may be found in the October 2004 draft Art 85; 2002 draft Art 85. The 2002 and October 2004 drafts gave shareholders the right to attend the creditors’ meeting, but only as non-voting delegates. 2004 draft Art 82; 2002 draft Art 83. The 2006 Enterprise Bankruptcy Law differs from the predecessor drafts in the role played by shareholders in the plan confirmation process. Article 85 of the 2006 PRC Enterprise Bankruptcy Law provides that a shareholder representative may attend the creditors’ meeting at which the draft reorganisation plan is discussed. Where the draft plan affects the rights and interests of shareholders, a group of investors is allowed to vote on the matter. Article 87(4) further provides that if the shareholder group votes against the plan, it is left for the court to determine if the adjustment of the rights and interests of the shareholders is fair and just.

117 Compare predecessor provisions in the October 2004 draft Art 86; 2002 draft Art 86.

118 Predecessor provisions may be found in the October 2004 draft Art 90; 2002 draft Art 91.

119 Predecessor provisions may be found in the October 2004 draft Arts 87, 89. Compare 2002 draft Art 90 (providing for a plan executor to be appointed and permitting the administrator to become the plan executor).

implementation of the reorganisation planned and declare the debtor bankrupt.<sup>120</sup>

70 This new reorganisation procedure dramatically improves upon the old laws. It includes many provisions and best practices found in other modern corporate rescue laws, although further judicial interpretations and supporting rules will be necessary for filling in the many gaps and providing greater detail. One of the novelties of the new law is providing the debtor with the ability to seek to retain control. This might well prove to be helpful in many cases, but greater clarity is necessary for setting out the procedures for allowing the debtor to remain in possession, especially when creditors prefer to have an administrator running the business.

71 There have been a few reorganisations carried out under the 2006 PRC Enterprise Bankruptcy Law. The first case involved a People's Court order approving a restructuring plan on 11 July 2007 for the Beijing Xianju Reproduction Health Centre. The case involved a pre-packaged plan in which the Vitoliti Medical Investment Ltd Co took over all of the assets and liabilities of the debtor, which amounted to RMB 9.9m of assets and RMB 21m of liabilities. Of the company's 39 creditors, 34 creditors voted in support of the plan, accounting for 98% of the debtor's liabilities. The five creditors that voted against the plan were all SOEs.<sup>121</sup> Other recent cases include the first bankruptcy declaration under the new law against an SOE, the General Company of Automobile Sales of China,<sup>122</sup> a reorganisation against a listed company,<sup>123</sup> and a bankruptcy case involving a foreign-owned company with foreign claims.<sup>124</sup>

#### **D. Priorities in distribution and the treatment of workers' interests**

72 The issues involving the treatment of worker's interests proved to be the most intractable in the drafting of China's new bankruptcy law and were primarily responsible for the last few years' delay in the promulgation of a new law.

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120 A predecessor provision may be found in the October 2004 draft Art 91.

121 Reported by Wang Weiguo at the IBA Singapore 2007 Conference, *supra* n 1.

122 See Zhang, "Developments Since the Adoption of the New Enterprise Bankruptcy Law of the PRC", *supra* n 32, at pp 4-5 (citing a report of China INSOL (25 January 2008) <[http://www.chinainsol.org/Article\\_Show.asp?ArticleID=1263](http://www.chinainsol.org/Article_Show.asp?ArticleID=1263)>).

123 *Ibid* (citing a report of China INSOL (30 January 2008) <<http://www.chinainsol.org>>).

124 *Ibid* (citing a report of China INSOL (25 January 2008) <<http://www.chinainsol.org>>).



73 In conflict were two different priority schemes in Chinese insolvency law. The 1986 Chinese Bankruptcy Law adopted the traditional approach of preferring the claims of secured creditors over the claims of workers. Article 32 of the 1986 Chinese Bankruptcy Law provided that secured creditors enjoyed priority over unsecured creditors to the extent of the level of their security. Article 37 of the 1986 Chinese Bankruptcy Law provided that after paying the expenses of the bankruptcy, the order of priority among unsecured creditors was as follows:

- (1) employees' wages and labour insurance expenses owed by the insolvent enterprise;
- (2) taxes owed by the insolvent enterprise; and
- (3) claims of unsecured creditors.<sup>125</sup>

74 Where there were enough assets to satisfy all claims within the same ranking, Art 37 of the 1986 Chinese Bankruptcy Law provided for the assets to be distributed *pro rata* within that ranking. Articles 56 to 58 of the 2002 PRC Supreme People's Court Provisions provided that the priority for workers' claims in Art 37 described above included severance pay owed to workers whose labour contracts were terminated due to the bankruptcy of the enterprise, labour compensation owed by the debtor to regular non-staff and workers (including temporary workers) and the pooled funds of the enterprise's staff and workers owed by the debtor, but not high interest thereon.

75 However, for SOEs subjected to the bankruptcy policy decrees, the priority scheme was quite different. The 1994 Notice provided that an SOE's land use rights should be sold by auction or by tender with the proceeds to be used for the resettlement of employees. The 1997 Notice made it clear that the resettlement rights of workers took priority over secured creditors. The workers' resettlement rights would initially be met by the land use rights (whether or not they were secured), and if that proved insufficient, by the disposal of non-secured and secured property. Where even that was insufficient, the People's Government of the same level as the SOE would be responsible for bearing the costs. Secondly, protection would also extend to certain pension and medical benefits of workers employed by SOEs without insurance policies to cover such entitlements.<sup>126</sup>

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125 Of course, for this distribution scheme to be applied in a given case, the government authority responsible for the SOE would have previously given its consent to the filing of the bankruptcy petition. A government authority would not generally provide its consent unless it was confident of its ability to provide for the resettlement of the SOE's workers.

126 For a discussion of the 1994, 1996, and 1997 Notices, see Wang & Booth, *supra* n 15, at pp 8–11 (Wang).

76 The reality was that there were two different priority schemes being used in Chinese bankruptcy cases – one that preferred the claims of secured creditors over workers (the 1986 law) and one that preferred workers' resettlement rights and other defined benefits over secured creditors (the policy decrees). As the drafting process progressed, debates arose about which of these models should be incorporated into the new law.

77 The 2002 draft retained the priority scheme of the 1986 law, with secured creditors getting paid first up to the level of their security, followed by the: (a) costs and expenses relating to the bankruptcy case (and public debts or debts of common benefit);<sup>127</sup> (b) wages of employees, social insurance and other relevant debts as provided under the labour law; (c) tax liabilities; and (d) general unsecured bankruptcy claims.<sup>128</sup> It also retained the rule for *pro rata* distributions where the assets were insufficient to pay all of the claims within a single ranking in full. Supplementing this general priority scheme in the 2002 draft Chinese bankruptcy law was Art 10:

The People's Court shall safeguard the lawful rights and interests of the employees of the bankrupt enterprises in accordance with the law when trying bankruptcy cases.

The People's Government of the place where the bankrupt enterprise is located shall properly arrange the settlement and lifetime guarantee of the rights of employees of the bankrupt enterprise.

78 The second paragraph of Art 10 mediated the conflict between the two competing priority schemes in China by putting the burden of providing for the settlement and lifetime guarantee of the rights of workers on the local governments.

79 The October 2004 draft Chinese bankruptcy law adopted a different approach to workers' rights. On the one hand, Art 8 appeared to cut back on the protection of workers' rights – although it retained the first paragraph of Art 10 of the 2002 draft, it omitted the second paragraph that put the onus on local governments to arrange for resettlement and guaranteed benefits – which was sensible given that the CSOP and other procedures would already have dealt with these issues for those SOEs most in need of assistance. On the other hand, the October 2004 draft priority scheme in Arts 113 and 127 substantially expanded worker protection under the bankruptcy law. These Articles provided that where there were insufficient funds to pay workers' claims

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127 2002 draft Chinese bankruptcy law Art 40 (providing that debts of common benefit are certain debts generated after the People's Court accepts a bankruptcy case, eg, a debt generated as a result of the administrator's request to perform a bilateral contract).

128 *Ibid*, Art 135.

in full (including unpaid wages, unpaid basic society insurance and other payments pursuant to administrative regulations and the law), the traditional priority ranking would no longer apply and the workers would get first priority over the rights of secured creditors from the assets securing the secured creditors' claims. In other words, the October 2004 draft exceeded the scope of the PRC bankruptcy policy decrees by giving *all* workers – and not just those in selected SOEs – priority over secured creditors.

80 This amendment took many by surprise, especially given that the additional government proposal accompanying the October 2004 draft provided that over the next few years 2,000 SOEs would be subject to “administrative closure” procedures pursuant to regulations to be prescribed by the State Council.<sup>129</sup> If the bankruptcy policy approach was to continue and “administrative procedures” would address the special problems faced by SOEs, including resettlement and the guarantee of lifetime benefits, then why was there a need not only to continue special protections for workers of SOEs, but even to extend these protections to non-SOE workers?

81 For approximately two years, the inability to resolve this issue led to the delay in the promulgation of a new bankruptcy law. Finally, in the summer of 2006, a compromise was reached regarding the rights of employees *vis-à-vis* secured creditors under the new law. This compromise was included in Art 132 of the 2006 PRC Enterprise Bankruptcy Law (in conjunction with Arts 109 and 113). The new law separates workers' claims into those arising *before* and those arising *after* 27 August 2006, the day the new law was promulgated.

82 Secured creditors are given priority over all workers' claims arising *after* 27 August 2006. In other words, the traditional approach – the protection of secured creditors rights before the payment of workers' claims – is adopted *vis-à-vis* all workers' claims arising after the promulgation of the new law. Secured creditors, pursuant to Art 109 of the new law, get paid first up to the level of their security, followed – pursuant to Art 113 – by the: (a) costs and expenses relating to the bankruptcy case (and public debts or debts of common benefit); (b) a broad range of worker benefits and entitlements;<sup>130</sup> (c) social

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129 See text accompanying *supra* nn 41–43.

130 Defined by 2006 PRC Enterprise Bankruptcy Law Art 113(1) to include: “[T]he salaries, expenses for medical treatment, injury or disability allowances and pensions owed by the bankrupt to its staff and workers, the basic old age insurance contributions and basic medical insurance contributions owed by the bankrupt and to be paid into individual accounts of its staff and workers, and the compensations payable to it staff and workers in accordance with the provisions of laws or administrative regulations[.]”

insurance benefits owed by the bankrupt other than those listed in (b) above<sup>131</sup> and tax liabilities; and (d) general unsecured bankruptcy claims.

83 However, a broad range of wage, medical and insurance claims of workers arising *before* 27 August 2006 – and still unsatisfied as of 1 June 2007 (the day the new law came into operation) – have priority over the claims of secured creditors. Article 132 defines these claims to include “salaries, expenses for medical treatment, injury or disability allowances and pensions, basic old age insurance contributions, and basic medical insurance contributions that shall be paid into individual accounts of staff and workers, and compensations payable to staff and workers in accordance with the provisions of laws or administrative regulations”.

84 The grandfathering protection for workers with pre-existing claims might well be substantial, as it is not uncommon for workers of SOEs to go for months, and, at times, for years, without wages. The special protection for SOE workers carries on the “iron rice bowl” approach and is thus, perhaps, understandable; however, it is difficult to explain why such protection is being extended to workers of non-SOE legal person enterprises who were not entitled to such protection under the old law.

85 Further protection for workers is included in Art 6 of the new law, which provides that the People’s Court shall “safeguard the lawful rights and interests of enterprises’ staff and workers and investigate for the legal liability of the managerial personnel of bankrupt enterprises”. Article 8 requires that in the case of a debtor’s petition, the debtor must file with the People’s Court with the bankruptcy petition the “preplan for resettlement of staff and workers, and the statements explaining the payment of salaries and social insurance contributions for it staff and workers”. Article 11 provides that in the case of a creditor’s petition, these documents shall be filed by the debtor within 15 days of receiving the order from the People’s Court of the court’s acceptance of the bankruptcy case.

#### ***E. Cross-border insolvency issues***

86 Increasingly, modern bankruptcies have provisions addressing both “inbound” and “outbound” cross-border insolvency issues. An inbound bankruptcy might involve a foreign representative (*eg*, a trustee or a liquidator) coming to China to seek recognition of a foreign bankruptcy, with perhaps the intention of gaining local co-operation in

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131 This is a change from the old bankruptcy laws and the predecessor drafts of the new bankruptcy law.

securing assets in China, and ultimately of obtaining permission to take such assets (or the proceeds from the sale of the assets) back to the foreign jurisdiction where the primary bankruptcy proceeding is being held. An outgoing bankruptcy would involve the opposite scenario in which a Chinese administrator travels overseas to seek recognition and co-operation from a foreign court. When considering these issues, judicial decisions may generally be divided into two paradigmatic approaches: the “territoriality approach” and the “universality approach”. If adopting the territoriality approach, a Chinese judge would refuse to recognise the extraterritorial application of a foreign jurisdiction’s laws and refuse to allow the foreign representative to claim the assets of the foreign debtor that are located within the Chinese court’s jurisdiction. In contrast, if adopting the universality approach, the Chinese judge would recognise the extraterritorial application of the foreign jurisdiction’s laws and allow the foreign representative to claim the assets of the foreign debtor that are located within the Chinese court’s jurisdiction.<sup>132</sup>

87 None of the old national PRC insolvency laws included provisions specifically applying to cross-border insolvency scenarios.<sup>133</sup> When confronted with inbound cross-border insolvency issues, Chinese courts traditionally adopted the territoriality approach.<sup>134</sup> However, the situation is changing. Hong Kong liquidators have reported over the last few years that they increasingly have been able to secure co-operation, especially in Guangdong. Moreover, in one of the series of annual meetings held between Hong Kong and Beijing insolvency professionals, the Beijing team noted that recognition of a Hong Kong liquidator might be more likely in a voluntary liquidation commenced by the company’s shareholders or directors than in a compulsory winding up.<sup>135</sup>

88 As for outbound transactions, Art 73 of the 2002 Supreme People’s Court Provisions provided that the bankrupt enterprise’s property located abroad shall be recovered by the liquidation committee. This provision had been interpreted by some commentators

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132 For further discussion of the territoriality and universality approaches, see Charles D Booth, “Living in Uncertain Times: The Need to Strengthen Hong Kong Transnational Insolvency Law” (1996) 34 Columbia J Trans’l L 389.

133 For a more detailed discussion of Chinese cross-border insolvency law prior to the enactment of the 2006 PRC Enterprise Bankruptcy Law, see Jingxia Shi, “Chinese Cross-Border Insolvencies: Current Issues and Future Developments” (2001) 10 Int’l Insolvency R 33.

134 See, eg, *Liwan District Construction Company v Euro-America China Property Ltd*, reported and commented on by Donald J Lewis & Charles D Booth, “Case Comment” (1990) 6 China L & Prac 27.

135 Meeting held in Beijing on 12 April 2001. See Zhang & Booth, *Beijing’s Initiative on Cross-Border Insolvency*, *supra* n 14, at 36.

as demonstrating that Chinese law was extraterritorial in scope; however, that conclusion did not naturally follow from this provision. The 2002 Supreme People's Court Provisions were intended to interpret the earlier Chinese bankruptcy laws but there was no provision in these laws dealing with cross-border insolvency for the 2002 Provisions to interpret. In the absence of such a provision in either the 1986 Chinese Bankruptcy Law or the PRC Civil Procedure Law, the better interpretation of Art 73 is that it was a creative way to assist the liquidation committee in recovering assets overseas, but any such recovery would have to be on the basis of the application of foreign – not Chinese – law.<sup>136</sup> In fact, when Japan's bankruptcy law was territorial, this was the approach that the Japanese courts adopted to enable Japanese liquidators to pursue property overseas and to administer such property in the Japanese bankruptcy proceedings in those cases in which the liquidators brought assets back to Japan.

89 The 2001 draft Chinese bankruptcy law was the first draft that included a provision on cross-border insolvency. Since then, all of the drafts have addressed this issue. Article 8 of the 2002 draft explicitly adopted the universality approach in regard to outbound transactions in providing that the new law would apply to a debtor's assets outside the PRC. This provision was retained in Art 7 of the October 2004 draft Chinese bankruptcy law and enacted in Art 5 of the 2006 PRC Enterprise Bankruptcy Law. It is a significant change for the new Chinese legislation to assert extraterritorial application, and the inclusion of such a provision will make it easier for Chinese representatives to seek assets and co-operation abroad. However, further thought should be given to whether the avoidance powers should also apply extraterritorially. The new Chinese law is silent on this issue.<sup>137</sup>

90 Unlike the treatment of outbound transactions involving Chinese assets abroad, the treatment of inbound transactions in the 2001 draft and onwards – including in the new 2006 PRC Enterprise Bankruptcy Law – is not as explicitly universal in scope. Article 8 of the 2002 draft provided that when, in the course of the foreign bankruptcy procedures, a foreign party applied for execution on the debtor's property located in the PRC, the People's Court *may* make a ruling of approval, except in the following cases:

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136 But see *CCIC Finance Ltd v Guangdong Int'l Trust & Inv Corp and Guangdong Int'l Trust & Inv Corp Hong Kong (Holdings) Ltd* HCA 15651 of 1999 (31 July 2001) (holding that China's old bankruptcy law was universal in scope and would be given recognition by the Hong Kong court).

137 For a discussion of this issue in the Hong Kong context, see Charles D Booth & Philip St J Smart, "The New Avoidance Powers under Hong Kong Insolvency Law: A Move from Territoriality to Extraterritoriality" (2000) 34 *Int'l Law* 255.

- (a) if there are no relevant treaties or reciprocal relations between the country and the PRC;
- (b) if the application violates the public interests of the PRC;
- (c) if the approval might impair the lawful interests or rights of the creditors in the PRC; and
- (d) if there are other factors that the People's Court thinks ought to be taken into consideration.

91 Article 7 of the October 2004 draft retained this provision with two important amendments: (1) subsection (d) was deleted, which removed the local judges' open-ended discretion; and (2) in the preamble, *may* was changed to *shall*. These changes limited the court's discretion and were intended to facilitate greater cross-border co-operation in cases where the factors were satisfied. The October 2004 approach has been incorporated for the most part into the new Art 5 of the 2006 PRC Enterprise Bankruptcy Law. This Article retains the need for co-operation to be grounded in either an international treaty or on the basis of reciprocity, provided that the foreign judgment or written bankruptcy order:

- (a) does not contradict the basic principles of the law of the PRC;
- (b) does not violate China's sovereignty, security, and social and public interest; and
- (c) does not infringe upon the lawful rights and interest of creditors within the PRC.

92 The language in Art 5 of the new law is arguably more restrictive than the October 2004 version as it includes a new provision denying co-operation on the basis that the basic principles of the PRC law have been contradicted. Under the October 2004 draft version, this factor would have been subsumed in the more general public interest test. Secondly, the public interest test has now been expanded to explicitly cover sovereignty, security and social interests.<sup>138</sup> However, like the October 2004 draft, the new provision removes the judges' open-ended discretion and makes co-operation compulsory (*shall*), where the factors are satisfied.

93 It is a significant improvement in the law that the rhetoric of this section rejects the territoriality approach of China's earlier bankruptcy laws. However, as China has not entered into any relevant

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138 Will the Chinese courts interpret the social interests as including the special protections for Chinese workers included in the new law?

treaties or reciprocal relations on cross-border insolvency, Art 5 is unlikely to have much impact at present. Not even China and Hong Kong have entered into a bilateral agreement on cross-border insolvencies,<sup>139</sup> although the topic has been discussed regularly at the annual meetings of the Hong Kong and Beijing insolvency professionals.<sup>140</sup>

## V. CONCLUSION

94 The wait for China's new bankruptcy law has ended. There is no doubt that the 2006 PRC Enterprise Bankruptcy Law offers dramatic improvements over the old bankruptcy law regime. A patchwork of legislation has given way to one national insolvency law, an administrator position has been created to take control and/or supervise the insolvency proceedings, the ability to reorganise debtors has been dramatically improved, and the territorial rhetoric of the old laws has been replaced. These are significant achievements. There is no denying that the new law is much more detailed and comprehensive than the old law. But there are still many gaps and uncertainties in the new legislation. Moreover, given the magnitude of the administrative solutions for resolving the dire straits of the SOEs, it is surprising that the Government thought it necessary to include such strong worker protection in the new legislation.

95 This article has highlighted five contentious issues that arose in the drafting of the new bankruptcy law. Although the 2006 PRC Enterprise Bankruptcy Law may have resolved many of these issues once and for all, it is also possible that debate on at least some of them will emerge yet again. For example, although many commentators highlight the harmonised, unified nature of the new law, it is clear that Chinese insolvency law will not be completely harmonised or unified unless, and until, the administrative closure of SOEs is concluded. And several important issues – such as how to handle the insolvency of financial institutions, partners and sole proprietors, and consumers – remain open. Similarly, a cross-border insolvency protocol between the PRC and Hong Kong has yet to be concluded. These are important areas that ideally should be finalised within the next few years.

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139 See Zhang & Booth, "Beijing's Initiative on Cross-Border Insolvency", *supra* n 14. This is one issue that the insolvency professionals from Hong Kong and Beijing continue to discuss.

140 For a discussion of how US courts might treat a request cross-border co-operation from a Chinese administrator or debtor-in-possession appointed in a case commenced under the 2006 PRC Enterprise Bankruptcy Law, see Good, *supra* n 32.



96 As highlighted many times, the ultimate success of the new Chinese insolvency law and the development of a corporate rescue culture depends in great part on the creation of supporting insolvency infrastructures. Thousands of professionals need to be trained in the workings of the new insolvency law and its procedures, including lawyers, accountants, commercial bankers, investment bankers, valuation experts, and regulators and other government officials. Training courses need to be established for those individuals and firms wishing to serve as administrators and for China's judges. Administrators and judges involved in insolvency matters need to be well versed not only in bankruptcy law, but also in company law, accounting and real estate matters. Insolvency cases generate lots of cash and procedures must be developed to protect against theft and corruption.

97 At this stage, the prudent course is to adopt a wait and see attitude to be better able to examine how the new law is interpreted by the courts and develops in practice.

98 It is important that the enactment of the law does not bring the reform era to an end. It is encouraging that many members of the Bankruptcy Law Drafting Working Group remain active in discussing the new law and in promoting its benefits and that international insolvency professionals in Hong Kong and throughout Asia are committed to assisting China in achieving international best practices. The developments over the next five to ten years will in great part allow us to see whether the potential of the 2006 PRC Enterprise Bankruptcy Law can be fully achieved.

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