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## Resolving Corporate Insolvencies in China: the Gap Between Law and Reality

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# Resolving Corporate Insolvencies in China: The Gap Between Law and Reality

Dr Zhang Zinian\*

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## *Abstract*

*This article examines how corporate insolvencies in China, the second largest economy, are handled under the current legislation, the China Enterprise Bankruptcy Law of 2006. Relying on the fresh empirical data arising from the first ten years on the use of China's three insolvency procedures, reorganization, composition and liquidation, this article reveals the huge gap between the law in the books and the law in action, arguing that the implementation of this law in China perhaps has not achieved the legislative objectives. The constitutional and institutional weaknesses affecting the application of this law are analyzed.*

*Key Words: China, Insolvency, Bankruptcy, Reorganization, Composition and Liquidation.*

## I. INTRODUCTION

In 2006, China promulgated its first rescue-oriented Enterprise Bankruptcy Law of 2006 (the EBL 2006) with the objectives of facilitating more corporate reorganizations, establishing a market-based corporate insolvency profession and of enhancing cross-border insolvencies. Given that more than ten years have passed after the new law became effective since 2007, time seems to be ripe to investigate whether the implementation of this law is a success or a failure. Bearing in mind this question, this article particularly sheds light on the use of the three corporate insolvency procedures, reorganization, composition and liquidation under this law and finds that unfortunately little improvement has been made in the past decade.

To explain why such a conclusion is reached, the article uses three parts to untangle the Chinese corporate bankruptcy law both in the books and in action. Part 1 gives a brief account about the history of China's bankruptcy law. Part 2 considers the main features of the EBL 2006 and examines the extent to which its legislative goals have been achieved. Part 3 analyses the three insolvency procedures, reorganization, composition and liquidation, under this law, investigating the contrast between law and reality. Some policy reflections are placed at the conclusion.

## II. HISTORIC DEVELOPMENT OF BANKRUPTCY LAW IN CHINA

China's first bankruptcy law can be traced back to 1905, when the Royal Court of the Qing Dynasty enacted the Bankruptcy Law of 1905,<sup>1</sup> which regulates the bankruptcy of both individuals and companies.<sup>2</sup> But this law was unexpectedly revoked in 1907 for unknown reasons.<sup>3</sup> Almost

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<sup>1</sup> XU Lizhi, Qing Mo Shangshi Lifa Yianjiu [Commercial Legislation in the Late Qing Dynasty] (Research Paper of the China Academy of Social Science Institute of Law) <https://iolaw.org.cn/showNews.aspx?id=2367>.

<sup>2</sup> CHANG NIEH-YUN, TRANSLATION OF THE CHINESE BANKRUPTCY CODE OF 1905 1-17 (1907).

<sup>3</sup> Chen Xiahong, Jingdai Zhongguo De Pochan Fazhi Jiqi Mingyun [The Modern China's Bankruptcy Laws and Their Fates], 28 Zhenfa Luntang [Tribune of Political Science and Law] 57, 60 (2010).

three decades later, in 1935, the China Legislative Yuan, the parliament of the republic government led by the Kuomintang Nationalist Party, promulgated the China Bankruptcy Law of 1935; unlike the 1905 bankruptcy law under which a bankruptcy procedure is mainly managed by a civil society, a local chamber of commerce, the 1935 Bankruptcy Law designates law courts to supervise the bankruptcy of both individuals and companies.<sup>4</sup>

Little is known about the extent to which the 1935 Bankruptcy Law was implemented, but one thing is certain: China was then in the military chaos between the republicans and the communist rebels. After the communists finally won the civil war in 1949, all legislations enacted by the republic government, including the 1935 bankruptcy law, were scrapped by the new regime in the mainland of China, although most of these laws are still in operation in the Taiwan Island to which the republicans retreated.<sup>5</sup>

After the communist party took control of China since 1949, perhaps because of the planned economy as well as the communist ideology,<sup>6</sup> using bankruptcy law to solve business failures seemed to be unnecessary, and even some communist ideologues believe they could build a bankruptcy-free economy.<sup>7</sup> Apparently, this was unrealistic, as late Mr. Cao Siyuan, a leading figure in China's central government in charge of drafting the first socialist bankruptcy law, argues that bankruptcy is inevitable in both socialist and capitalist economies.<sup>8</sup> It is not a surprise that, under the pressure to deal with money-losing state-owned enterprises (SOEs),<sup>9</sup> China, early in the 1980s, eventually resumed the effort to make a bankruptcy law, which resulted in the promulgation of the China Enterprise Bankruptcy Law of 1986 (the EBL 1986).<sup>10</sup>

Given the dominant state sector in the Chinese economy when the EBL 1986 was made, this law only applies to SOEs.<sup>11</sup> It is noteworthy that the real policy intention of enacting the EBL 1986 is arguably not to

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<sup>4</sup> Article 2 of the China Bankruptcy Law of 1935.

<sup>5</sup> Chen Xiahong, *Mingguo Pochanfa De Qicao zhai* [The Draftsman of the 1935 China Bankruptcy Law], *Fazhi Ribao* [Legal Daily] Oct. 27, 2016, 11.

<sup>6</sup> Cao Siyuan, *Shi Lun Shixing Qiye Pochanfa De Biyao Xing* [The Necessity of Enforcing a Law of Bankruptcy in China], 5 *Gai Ge* [Reform] 25, 26 (1985).

<sup>7</sup> Cao Siyuan, *Guanyu Zhiding Pochanfa De Jiangyi* [Proposal to Make a Bankruptcy Law in China], 11 *Shehui Kexue* [Social Sciences] 42 (1984).

<sup>8</sup> Chen Jianfu, *The Making of an Enterprise Bankruptcy Law in the PRC*, 25 *Law Context: A Socio-Legal Journal* 77, 78 (2007).

<sup>9</sup> Carsten A Holz, *Economic Reforms and State Sector Bankruptcy in China*, 166 *China Quarterly* 342, 343 (2001).

<sup>10</sup> Peng Xiaohua, *Characteristics of China's First Bankruptcy Law*, 28 *Harv. Int'l L. J.* 373 (1987).

<sup>11</sup> Article 2 of the EBL 1986.

liquidate inefficient and bankrupt SOEs as well as not to protect creditors,<sup>12</sup> rather the Chinese decision-makers aimed to use this law to warn SOEs to operate more efficiently.<sup>13</sup> The EBL 1986 has two bankruptcy procedures, reorganization and liquidation. As noted by Professor Wang Weiguo, reorganization under this law is probably never used in practice,<sup>14</sup> partly because of its procedural absurdity.<sup>15</sup> Although several thousands of enterprise bankruptcy liquidation cases in total were dealt with by the Chinese courts following the promulgation of this law before the EBL 2006 was enacted, first, over half of these cases were actually to liquidate so-called collectively-owned enterprises,<sup>16</sup> which are managed either by local government or by their parent SOEs, and second, the bankruptcy of most failed SOEs was handled by the government through administrative channels.<sup>17</sup>

Arguably, to make the Chinese enterprise bankruptcy law look more inclusive, or perhaps to alleviate the criticism that SOEs and other enterprises are treated unequally at least in theory, when drafting the China Civil Procedure Law of 1991, the China People's Congress inserted a chapter on the bankruptcy for non-SOE enterprises, including private and foreign-invested ones, Chapter 19, into this law.<sup>18</sup> Similar to the EBL 1986, the bankruptcy chapter in the Civil Procedure Law of 1991 also has two major bankruptcy procedures, reorganization and liquidation. But this chapter shares the same weakness with the EBL 1986: both are overly skeleton and considerably vague.<sup>19</sup> This led to some commenting that the Chinese bankruptcy law is more like a policy statement rather than a law full of details intended to be used in practice.<sup>20</sup> Up until then, at least on the statutory books, it seems that China has fully established the

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<sup>12</sup> Douglass G Boshkoff & Yongxin Song, *China's New Bankruptcy Law: A Translation and Brief Introduction*, 61 Am. Bankr. L. J. 359, 361 (1987).

<sup>13</sup> *CCIC Finance Ltd v Guangdong International and Investment Corp.* [2005] HKEC 1180.

<sup>14</sup> Weiguo Wang, *Adopting Corporate Rescue Regimes in China, A Comparative Survey*, 9 Aust. J. Corp. L. 234, 238 (1998).

<sup>15</sup> Michael Minor & Karen J Stevens-Minor, *China's Emerging Bankruptcy Law*, 22 Int'l Law. 1217, 1221 (1988).

<sup>16</sup> Li Shuguang, *Bankruptcy Law in China: Lessons of the Past Twelve Years*, 3 Harv. Asia Q. 1 (2006).

<sup>17</sup> Weiguo Wang & Charles Booth, 'Study on Alternative Approaches for Debt Restructuring of Enterprises in China' (Report of the Project on 'Debt Restructuring of Enterprise from the State Economy and Trade Commission of China) 29-30.

<sup>18</sup> Chapter 19 of the China Civil Procedure Law 1991.

<sup>19</sup> Michael Minor & Karen J Stevens-Minor, *China's Emerging Bankruptcy Law*, 22 Int'l Law. 1217, 1220 (1998).

<sup>20</sup> Donald C Clarke, 'China, Creating a Legal System for a Market Economy' (Asian Development Bank 2007) 7.

bankruptcy law system for enterprises in all ownerships, although China has not yet made a bankruptcy law for individuals since.<sup>21</sup>

As mentioned before, in spite of an inclusive bankruptcy system on the statute books, translating the law into reality remained a formidable challenge; in general, both bankruptcy laws were only occasionally used by local government, through local courts, to liquidate enterprises that were state- or collectively-owned,<sup>22</sup> by contrast, for private companies, the bankruptcy law was virtually not available.<sup>23</sup>

Apparently, the dire situation of the implementation of the bankruptcy law did not catch up with China's unprecedented economic growth especially after China's accession to the WTO in 2001 as well as the rapid expansion of the Chinese private economies;<sup>24</sup> the calls for an effective corporate bankruptcy system from inside China and outside grew louder,<sup>25</sup> and this resulted in the promulgation of a unified enterprise bankruptcy law, the EBL 2006, years after China was admitted to the WTO.<sup>26</sup> Many believe that China enacted the modern EBL 2006 in an effort to provide an orderly exit for failed businesses and to protect creditors,<sup>27</sup> but some doubt that the promulgation of the EBL 2006 might superficially serve as a legislative gesture to impress China's WTO partners, only.<sup>28</sup>

### III. MAJOR FEATURES OF THE CHINA ENTERPRISE BANKRUPTCY LAW OF 2006

In fact, China's endeavor to revamp its enterprise bankruptcy law began as early as in 1994,<sup>29</sup> and twelve years later it finally bore fruit: The

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<sup>21</sup> Haizheng Zhang & Xiaohe Tan, 'Bankruptcy Petition and Acceptance' in CHINA'S NEW ENTERPRISE BANKRUPTCY LAW: CONTEXT, INTERPRETATION AND APPLICATION 76 (Rebecca Parry, Yongqian Xu and Haizheng Zhang eds., 2010).

<sup>22</sup> Shuguang Li, *Bankruptcy Law in China: Lessons of the Past Twelve Years*, 3 Harv. Asia Q. 1 (2006).

<sup>23</sup> Sheryl Miller, *Institutional Impediments to the Enforcement of China's Bankruptcy Laws*, 8 Int'l Legal Persp. 187, 191 (1996).

<sup>24</sup> Joseph Kahn, 'World Trade Organization Admits China, Amid Doubts' *New York Times* (New York 11 November 2001) A16.

<sup>25</sup> United States Trade Representative, '2016 Report to Congress on China's WTO Compliance' (January 2017) 170.

<sup>26</sup> Tom Young, *Enterprising Reform: China's New Bankruptcy Law Represents More Than Comfort for Creditors*, 26 Int'l Financial L. Rev. 60 (2007).

<sup>27</sup> OECD, CHINA, DEFINING THE BOUNDARY BETWEEN THE MARKET AND THE STATE 53 (2009).

<sup>28</sup> Campbell Korff & Xinhong Liu, *Why China's Insolvency Regime Must Improve*, 21 Int'l Financial L. Rev. 33, 35 (2002).

<sup>29</sup> Weiguo Wang, *Corporate Governance and the Draft Bankruptcy Law of China*, 17 Aust. J. Corp. L. 111, 112 (2004).

EBL 2006 was passed by the China People's Congress Standing Committee, the executive branch of the Chinese parliament, on 27 August 2006, taking effect from 1 June 2007.<sup>30</sup> In the course of drafting the EBL 2006, the lawmakers studied the bankruptcy law from a number of jurisdictions, including the USA, UK, France and Germany; and it is fair to say that the American Chapter 11, to a large extent, helped reshape the EBL 2006.<sup>31</sup> But the lawmakers, it seems, did not effectively consult their own business people when deliberating this law, which is a key constitutional defect of the Chinese law-making. Compared with the previous bankruptcy statutes, however, the EBL 2006 marks a significant step forward on a number of fronts.

First, the EBL 2006 is the first rescue-oriented bankruptcy law in China. It comprises three substantial chapters, chapters 8 on reorganization, 9 on composition and 10 on liquidation; the order of the three chapters, arguably, reflects the intention of the Congress to prioritize the use of reorganization.<sup>32</sup> If this is true, it may rather ironically expose the naivety of these lawmakers, since the primary goal of a bankruptcy law, arguably, is to liquidate inefficient and bankrupt businesses.<sup>33</sup> Unfortunately, at least from 2007 to 2015, the new rescue procedure under the EBL 2006 was only occasionally used – in most years less than 100 reorganization cases can be identified in China – at the request of local government, to rehabilitate some large companies in China,<sup>34</sup> and even it is safe to say that the new corporate reorganization procedure is virtually not available for businesses in practice, mainly due to the weak rule of law in the country. Chinese law courts routinely ignore the reorganization judicial demands from desperate businesses.

To promote corporate rescues, under the EBL 2006 Article 2, a company that is bankrupt or is likely to be bankrupt can enter into the voluntary reorganization procedure, which means that an early rescue can be attempted at a time when the company is on the verge of bankruptcy rather than is already in a bankruptcy trouble,<sup>35</sup> but this Article falls short

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<sup>30</sup> The preface of the EBL 2006.

<sup>31</sup> Weiguo Wang, *Adopting Corporate Rescue Regimes*, 9 Aust. J. Corp. L. 234 (1998).

<sup>32</sup> Zou Hailin, Woguo Qiye Zaishen Chenxu De Zhidu Fengxi He Shiyu [China's Corporate Reorganisation Procedure: Theories and Practice], 25 *Zhengfa Luntan* [Tribune of Political Science and Law] 48, 50-1 (2007).

<sup>33</sup> Bruce G Carruthers & Terence C Halliday, *Institutionalizing Creative Destruction: Predictable and Transparent Bankruptcy Law in the Wake of the East Asian Financial Crisis*, in MEREDITH JUNG-EN WOO (ED), *NEOLIBERALISM AND INSTITUTIONAL REFORM IN EAST ASIA: A COMPARATIVE STUDY* 244 (2007).

<sup>34</sup> ZHANG ZINIAN, *CORPORATE REORGANISATIONS IN CHINA: AN EMPIRICAL ANALYSIS* CHAPTER 2 (2018).

<sup>35</sup> Wang Liming, Pochan Lifa Zhong De Ruogan Yinan Wenti Tantaotao [The Enterprise Bankruptcy Bill: An Analysis], 3 *Fa Xue* [Legal Science] 3, 11 (2005).

of unequivocally clarifying that a company placed in a voluntary bankruptcy reorganization procedure does not need to show the evidence of bankruptcy.<sup>36</sup> Not surprisingly, in reality, this legal innovation under the EBL 2006 is simply disregarded by Chinese courts, since opening an in-court corporate reorganization procedure, as evidenced in the existing reorganizations, still needs to pass both the cash flow and balance sheet bankruptcy tests.<sup>37</sup>

To improve the feasibility of a corporate rescue, the EBL 2006 Article 73 allows the debtor, especially its board of directors, to manage the company's assets and business affairs during the reorganization procedure, which means the debtor-in-possession model under the American Chapter 11 has been transplanted into the Chinese bankruptcy law.<sup>38</sup> But, the Chinese version of debtor-in-possession is slightly different from that under Chapter 11.

On the one hand, the Chinese debtor-in-possession model is a conditional one: Where a reorganization procedure is commenced, a bankruptcy administrator will be simultaneously appointed by the court to take control of the company; but the debtor is, under the EBL 2006 Article 73, eligible to apply for debtor-in-possession afterwards, and if approved by the court, the bankruptcy administrator will return the control of the company to the debtor. The concern here is that Article 73 does not specify what conditions must be met when the court assesses the debtor-in-possession application.<sup>39</sup> It is equally true that if the debtor does not apply or if the court rejects the application, the company in reorganization will continue being controlled and managed by the court-appointed bankruptcy administrator. By contrast, the debtor-in-possession model under the US Chapter 11 is a default one and is routinely used.<sup>40</sup>

On the other hand, if granted, the Chinese debtor-in-possession, compared with Chapter 11, seems to be more generous to the debtor: The debtor in possession under the EBL 2006 will be given the exclusive right of proposing a reorganization plan during the entire reorganization procedure;<sup>41</sup> in comparison, its American counterpart's monopoly on this is only limited during the first 120 days.<sup>42</sup> Some argue that others parties could be allowed to propose a competing reorganization plan, which is

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<sup>36</sup> 11 USC § 301.

<sup>37</sup> See note 34 above at chapter 2 especially.

<sup>38</sup> Emily Lee, *The Reorganisation Process under China's Corporate Bankruptcy System*, 45 Int'l Law. 939, 942 (2011).

<sup>39</sup> Yongqing Ren, *The 'Control Model' in Chinese Bankruptcy Reorganisation Law and Practice*, 85 Am. Bankr. L. J. 177, 180 (2011).

<sup>40</sup> 11 USC § 1104 and § 1107.

<sup>41</sup> The EBL 2006 Article 80.

<sup>42</sup> 11 USC § 1121 (b).



subject to the vote of affected parties, and the current restriction under the EBL 2006, it seems, cannot be justified.<sup>43</sup>

Although many argue that the use of debtor-in-possession should be the norm rather than the exception under the EBL 2006, especially given that it encourages an early rescue and can take advantage of the expertise of former managers, an empirical study suggests it is only applied in less than twenty per cent of the existing corporate reorganizations in China, and more importantly, the debtor-in-possession in action might have considerably deviated from the original design, since although the debtor-in-possession is superficially installed, many key reorganization decisions are still made by court-appointed administrators.<sup>44</sup>

Meanwhile, to facilitate more rescue outcomes, under the EBL 2006 Article 87, in the event that a reorganization plan has been voted down by either the meeting of creditors or of shareholders or both, it may still be forcibly approved by the court if certain statutory conditions are satisfied, which means a Chapter 11-style cram down is also adopted by the EBL 2006. Overall, the EBL 2006 appears to be considerably rescue-oriented.

Second, the EBL 2006 evolves from the old law under which an enterprise bankruptcy procedure relies on a local government organized liquidation committee to manage the estate<sup>45</sup> to an international 'best practice' whereby an insolvency administrator, who may be chosen from qualified lawyers or accountants, will be appointed to do the job, namely the new law embraces insolvency professionalism.<sup>46</sup> Article 24 of the EBL 2006 authorizes the China Supreme People's Court to make the rules on the qualification and remuneration of insolvency practitioners in bankruptcy services.

Creating an insolvency practitioner system in China by the EBL 2006 is widely acclaimed domestically and internationally,<sup>47</sup> since using qualified practitioners to manage companies in bankruptcy may considerably reduce government intervention so as to improve fairness and efficiency of the corporate bankruptcy system. But the problem is that the EBL 2006 Article 24 still retains government-organized liquidation committees, alongside qualified insolvency practitioners, to be appointed as bankruptcy administrators. Although the lawmakers' intention,

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<sup>43</sup> Rakhi I Patel, *A Practical Evaluation of the People's Republic of China's 2007 Enterprise Bankruptcy Law*, 10 U.C. Davis Bus. L. J. 109, 114 (2009).

<sup>44</sup> See note 34 above at chapter 2.

<sup>45</sup> The EBL 1986 Article 24, and the China Civil Procedure Law 1991 Article 201.

<sup>46</sup> The EBL 2006 Article 24.

<sup>47</sup> Charles D Booth, *The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over*, 20 Singapore Academy of Law Journal 275, 292-5 (2008).

arguably, is to reserve such committees only for the bankruptcy of SOEs,<sup>48</sup> this has not been clearly written in the law, which may result in confusion or abuse.<sup>49</sup>

Another problem of China's new insolvency practitioner system is that it is the law court that can appoint a bankruptcy administrator, and that both debtor and creditor are not allowed to make a nomination, let alone an appointment. Given the poor record of the Chinese court system on judicial independence and on corruption,<sup>50</sup> this may cast a shadow over whether bankruptcy administrators will prioritize the interest of creditors and over whether government intervention through law courts will persist in China's corporate bankruptcies.<sup>51</sup> But it seems fair to say that establishing the Chinese insolvency profession itself is a step forward in the right direction.

But the major concern is that there are few cases for newly qualified insolvency practitioners in China to gain experience. Following the enactment of the EBL 2006, the China national number of corporate bankruptcy cases surprisingly declined from 4,755 in 2006 to 2059 in 2014.<sup>52</sup> Given the size of the Chinese economy, such numbers means that for the majority of newly qualified insolvency practitioners there is no bankruptcy case to practice. Without having real bankruptcy businesses, it is virtually impossible for this new profession to develop.

Third, the EBL 2006 advocates collaboration on cross-border insolvencies, and its Article 5 uses the modified universality principle to deal with these challenges.<sup>53</sup> This is somewhat due to the influence of the UNCITRAL Model Law on Cross Border Insolvency, which was published in 1997<sup>54</sup> and helped remind some Chinese liberal scholars who

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<sup>48</sup> Jiang Qiangui, *Zhonghua Renmin Gongheguo Qiye Pochanfa Caoan Xiuga Qingkuang De Huibao* [Report of the Revisions on the China Enterprise Bankruptcy Bill], 7 *Quanguo Renmin Daibiao Dahui Changwu Weiyuanhui Gongbao* [The Journal of the China People's Congress Standing Committee] 579, 581 (2006).

<sup>49</sup> Li Shuguang & Wang Zuofa, *Zhongguo Pochanfa Shishi Sannian Lai De Shizhen Fengxi: Lifa Yuqi Yu Sifa Shijian De Chaju Jiqi Jiejue Lujing* [The Gap between Expectation of Legislation and Judicial Practice and its Resolution: Empirical Analysis of Bankruptcy Law's Three-Years Implementation], 2 *Zhengfa Luntan* [The Journal of China University of Political Science and Law] 58, 62 (2011).

<sup>50</sup> Ling Li, *The 'Production' of Corruption in China's Courts: Judicial Politics and Decision Making in a One-Party State*, 37 *Law & Soc. Inquiry* 847, 877 (2012).

<sup>51</sup> Roman Tomasic & Zinian Zhang, *The Political Determinants of Corporate Reorganisation in China*, in *ROUTLEDGE HANDBOOK OF ASIAN LAW* 125 (Christoph Antons ed., 2017).

<sup>52</sup> These figures are from the China Law Yearbook (2003-2014).

<sup>53</sup> Jay Lawrence Westbrook, *A Global Solution to Multinational Default*, 98 *Mich. L. Rev.* 2296 (2000).

<sup>54</sup> United Nations Commission on International Trade Law (UNCITRAL), *UNCITRAL Model Law on Cross-Border Insolvency*

joined the making of the EBL 2006 to be open-minded.<sup>55</sup> In particular, this Article states that a corporate bankruptcy ruling by a Chinese court binds the company's assets located domestically and abroad, and that equally a foreign bankruptcy ruling can also bind the company's assets located in China but on the condition that such a ruling must be recognized by a Chinese court in the first place.<sup>56</sup> This Article sets up some restrictions on recognition of a foreign bankruptcy judgement.

Specifically, for an overseas bankruptcy judgement, the foreign country must have a judicial assistance treaty, bilateral or multilateral, with China, and if not, reciprocity on this must have been established; more important is that recognizing a foreign bankruptcy judgement cannot violate China's fundamental legal principles, sovereignty, national security and public interests, in addition to the rights of domestic creditors.<sup>57</sup> Some argue that the tone of this Article is considerably hostile, which might make recognition of foreign bankruptcy judgements a difficult task.<sup>58</sup> It is also worth noting that China has not yet ascertained what fundamental legal principles, sovereignty, national security and public interests really mean, and such vagueness may lead to much uncertainty. With regard to reciprocity, the attitude of the Chinese court system seems to be that a foreign country must show goodwill at first by recognizing a Chinese law court ruling, and it appears that no Chinese court has, unilaterally and proactively, recognized a foreign court judgement so as to pave the way for establishing the reciprocity, although many call the Chinese courts to be forward-thinking and internationally friendly.

As for the worldwide effect of China's corporate bankruptcy rulings, many doubt that this is somewhat self-deceiving, since before being recognized by a foreign court, a Chinese bankruptcy ruling is meaningless on a foreign land; but supporters insist that it better than to say nothing.<sup>59</sup> Of course, a Chinese corporate bankruptcy ruling must be recognized by a foreign court prior to legally binding the company's assets residing overseas.

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<[http://www.uncitral.org/uncitral/en/uncitral\\_texts/insolvency/1997Model.html](http://www.uncitral.org/uncitral/en/uncitral_texts/insolvency/1997Model.html)>  
accessed 1 December 2017.

<sup>55</sup> Wang Weiguo, Zou Hailin and Li Yongjun, Pochan Fa Shinian [Ten Years of Drafting the Enterprise Bankruptcy Law] (Seminar of the Civil and Commercial Law Centre, China University of Political Science and Law, 12 March 2004) 1.

<sup>56</sup> The EBL 2006 Article 5 Paragraph 1.

<sup>57</sup> The EBL 2006 Article 5 Paragraph 2.

<sup>58</sup> Steven J Arsenault, *Leaping over the Great Wall: Examining Cross-Border Insolvency in China under the Chinese Corporate Bankruptcy Law*, 21 *Ind. Int'l & Comp. L. Rev.* 1, 22 (2011).

<sup>59</sup> See note 53 above.

In practice, seeking the recognition of a foreign bankruptcy ruling in a Chinese court by relying on the EBL 2006 Article 5 seems to be a formidable task; after the EBL 2006 took effect since 2007, there was no reported recognition of foreign bankruptcy judgements. The recent two high profile cases, the bankruptcy rehabilitation of Hanjin Shipping Limited in 2016 taking place in South Korea<sup>60</sup> and the administration of Lehman Brothers (Europe) Limited in 2008 opened in the UK,<sup>61</sup> both of them having assets located in China, suggest that some, if not most, Chinese courts may not only ignore foreign bankruptcy rulings but also turn a blind eye to the recognition application by foreign bankruptcy office-holders.<sup>62</sup> On the contrary, obtaining the judicial recognition of a Chinese bankruptcy ruling abroad is relatively easy, especially in some advanced jurisdictions that have adopted the UNCITRAL Model Law on Cross-Border Insolvency; years ago, a corporate reorganization ruling from a Zhejiang court in China was recognized in the USA, serving a good example on this.<sup>63</sup>

To sum up, at the first glance, the EBL 2006 looks very modern and seems to be similar with the bankruptcy legislations in many developed jurisdictions, but the greatest challenge is how to translate the law into practice, especially given China's weak judicial system and the lack of the respect to the rule of law. Specifically, more problems can be identified by examining the use of the three major insolvency procedures in China since 2007.

#### IV. THE THREE CORPORATE INSOLVENCY PROCEDURES UNDER THE EBL 2006

As noted above, the EBL 2006 comprises three major corporate insolvency procedures, reorganization, composition and liquidation. Under the old EBL 1986, there is also a corporate reorganization

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<sup>60</sup> Shi Jingxia & Huang Yuanyuan, *Kuajie Pochan Zhong De Chenren Yu Jiuji Zhidu: Jiyu Hanjin Pochan An De Guancha Yu Fengxi* [The Recognition and Relief in Cross-Border Insolvency – a Perspective from Hanjin Shipping Co.,] 2 *Zhongguo Renmin Daxue Xuebao* [Journal of Renmin University of China] 34, 35 (2017).

<sup>61</sup> Fenxiang Zhang, Cong Huaan Jijing Yu Leiman Ouzhou Jingrong Yanshen Chanping Touzi Hezuo An Kan Woguo Xiangguan Falu Zhidu De Wanshan [Lessons of Hua An v Lehman Brothers Europe], in *Jingrong Fazhi Qiangyan* [HERALD OF RULE OF LAW ON FINANCE] 79 (Yong Qing ed., 2011).

<sup>62</sup> Steven T Kargman, *Emerging Economies and Cross-Border Regimes: Missing BRICs in the International Insolvency Architecture (Part II)*, 7 *Insolvency and Restructuring International* 6, 8-9 (2013).

<sup>63</sup> *In Re Zhejiang Topoint Photovoltaic Co., Ltd* [2015] United States Bankruptcy Court for the District of New Jersey 14-24549.

procedure, but it is too rudimentary to match its title;<sup>64</sup> more strikingly, as noted before, the old reorganization procedure probably has never been used. In contrast, the reorganization procedure under the EBL 2006 is far more comprehensive and reflects many rescue mechanisms used in some advanced jurisdictions.<sup>65</sup>

*a. The Reorganization Procedure under the EBL 2006*

*Reorganization applicants:* Under the EBL 2006 Article 7, both the debtor and its creditors can file for the reorganization of the company before a local court; as noted above, in the case of a voluntary filing, under the EBL 2006 Article 2, even the company that is not bankrupt but is likely to be bankrupt can enter into reorganization at an early stage. Again, as mentioned before, this provision is virtually neglected in practice, although the legislative intention is well presented.

For creditor applicants, the EBL 2006 Article 7 is clear: where the debtor company is unable to pay the debt which is due, the creditor can file for the bankruptcy reorganization of the debtor, which means passing a cash-flow bankruptcy test is sufficient for a creditor to bring a defaulting debtor into a bankruptcy reorganization procedure. The reality, however, is that this provision is also flouted by Chinese courts; instead, according to the existing reorganization filings, for a filing creditor, one of the conditions to commence a corporate reorganization procedure is to convince courts that both cash-flow and balance-sheet bankruptcy tests are satisfied.<sup>66</sup> These make the entry of reorganization considerably difficult.

To start a reorganization procedure, except a straightforward reorganization application filed either by the debtor or by its creditors, in the event of an involuntary liquidation procedure, the debtor or its shareholder(s) holding more than ten per cent of the company's equity may, under the EBL 2006 Article 70, apply to the court to convert liquidation into reorganization. But the concern here is that if the company is already financially insolvent, in view of the fact that shareholders might have no substantial interest in the company, empowering shareholders to change the course of bankruptcy might be financially unjustifiable. More problematic is that whether to convert liquidation into reorganization should be ultimately decided by the court rather than by the creditors, and

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<sup>64</sup> Rebecca Parry & Haizheng Zhang, *China's New Corporate Rescue Laws: Perspectives and Principles*, 8 *Journal of Corporate Law Studies* 113, 117 (2008).

<sup>65</sup> Steven J Arsenault, *The Westernization of Chinese Bankruptcy: An Examination of China's New Corporate Bankruptcy Law through the Lens of the UNCITRAL Legislative Guide of Insolvency Law*, 27 *Penn St. Int'l L. Rev.* 45, 83 (2008).

<sup>66</sup> See note 34 above at chapter 2 especially.

this may rather undermine creditor protection in corporate bankruptcy procedures in China. But the key legislative message here is clear: the EBL 2006 advocates the entry of reorganization.

An early empirical study suggests that some sixty per cent of the surveyed corporate reorganization applicants under the new EBL 2006 are debtors and the rest of them are creditors; a conversion from liquidation into reorganization happens only in around five per cent of all reorganizations. But it is worth addressing that whoever is the reorganization applicant, without the political support of local government, opening an in-court corporate reorganization is highly unlikely.<sup>67</sup> Local government not only plays a key role in deciding whether a reorganization procedure can be initiated but also takes control of judicial corporate reorganizations thereafter in one form or another.

*Control models of China's corporate reorganizations:* Whatever a reorganization, composition or liquidation procedure, under the EBL 2006 Article 13, an insolvency practitioner, which is, in many cases, a qualified law or accounting firm, will be immediately appointed by the court as the bankruptcy administrator to take control of the company by replacing the previous management. But given that reorganization is aimed to rehabilitate rather than to liquidate companies in trouble, as noted before, following the beginning of a reorganization procedure, under the EBL 2006 Article 73, the debtor, particularly the company's management, can apply to the court for debtor-in-possession. It is equally true that the court-appointed administrator will remain in office if the debtor does not apply for debtor-in-possession or if its application is rejected by the court. Hence, the control model of China's corporate reorganizations seems to be a hybrid, embracing both the practitioner- and debtor-in-possession model widely used in the UK and the USA respectively.

In reality, debtor-in-possession is not used as frequently as expected in China, since it is found that the conversion from practitioner- into debtor-in-possession is only approved in some eighteen per cent of the surveyed reorganizations.<sup>68</sup> But the real challenge is that the current debtor-in-possession might have substantially deviated from what is originally intended in the EBL 2006, because although debtor-in-possession is allowed, many key decisions are still made by court-appointed administrators; for example, in many surveyed cases, debtor-in-possession is somewhat used to merely retain the previous management to maintain the day-to-day operation of the company in reorganization, but some vital decisions, like choosing a company buyer, are actually made

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<sup>67</sup> Huimiao Zhao, *Reorganisation of Listed Companies with Chinese Characteristics*, 91 *Am. Bankr. L. J.* 87 (2017).

<sup>68</sup> See note 34 above at chapter 3.

by reorganization administrators. In this situation, the debtor occupies the driving seat under the debtor-in-possession model, but the substantial decision-making is in the hands of court-appointed administrators who are supposed to be supervisors only.

What should be pointed out is that whether debtor-in-possession is used or not, local government, to a large extent, controls the reorganization of a local company in one way or another.<sup>69</sup> For example, a liquidation committee might be formed by local government and is later appointed by the court as the reorganization administrator; sometimes, local government stays in the shadow by forming a political supporting committee to direct the course of the reorganization of a local large company, which might be a state-owned or even a private enterprise;<sup>70</sup> so in real terms, arguably, China uses a kind of government-in-possession in its corporate reorganizations, which might be an entire departure from what is originally envisaged.<sup>71</sup>

*Corporate reorganization plans:* Under the EBL 2006 Article 79, a reorganization plan must be proposed within six months after the company entered into reorganization, and a three-month extension can be granted by the court on request, if the court believes that it is reasonable. Using the word “reasonable” somewhat means that an extension can be given fully at the discretion of the court.

But it seems to be a surprise that a reorganization plan can only be exclusively proposed by the administrator if debtor-in-possession is not in use, and that such a monopoly is offered to the debtor otherwise. Other parties, especially creditors, are not officially allowed to propose an alternative reorganization plan for a vote.

But in practice, given that most China’s corporate reorganizations use company sale rescues, a reorganization plan is more or less the result of an intense bargaining between major creditors and company buyers;<sup>72</sup> namely the real reorganization plan makers are major creditors and company buyers instead of debtors or administrators; therefore, to a certain extent, it seems that it is not a matter of concern over who is officially eligible to propose a reorganization plan. Of course, ideally, when amending the EBL 2006, other key parties, including creditors and

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<sup>69</sup> Ding Yan, *Shangshi Gongsi Chongzhen Zhong Xingzhenquan Yunxing De Pianli Yu Jiaozhen* [Government Intervention in the Reorganisations of Listed Companies in China], 31 *Faxue Luntan* [Legal Forum] 122, 127 (2016).

<sup>70</sup> Changyin Han, *The Practice of Reorganisation in China*, 33 *Ariz. J. Int’l & Comp. L.* 275, 281-2 (2016).

<sup>71</sup> See note 34 above at chapter 2.

<sup>72</sup> See note 34 above at chapter 6.

members, could be given the chance to make a competing rescue proposal.<sup>73</sup>

Under the EBL 2006 Article 81, a reorganization plan may comprise two substantial elements, one to update the company's business operation and the other to restructure the company's debts. This Article does not mention how to deal with the equity of the company in a reorganization plan, and probably it leaves this gap for stakeholders to fill in practice. Bearing in mind the prevalent company sale reorganizations in China, the content of most reorganization plans is on how to restructure the company's debts, and usually there is little ink spilled on how to reorganize the company's business; probably revitalizing the company's business is better left for company buyers to sort out subsequent to the judicial reorganization procedure.

A reorganization plan, under the EBL 2006 Articles 86 and 87, will not take effect unless it successfully goes through the two stages, first a vote by the creditors and second an approval by the court. For the voting purpose, under the EBL 2006 Article 82, creditors are separated into four classes, the secured, employee, tax, and ordinary unsecured creditors, to vote on the proposed reorganization plan; the plan, a reorganization proposal, is passed if it is voted for by over half of the attending creditors holding over two-thirds of the claims in each class. Under the EBL 2006 Article 86, a reorganization plan that has been voted in favor by all classes of creditors may be submitted to the court for confirmation/approval; the court will approve the voted plan if it believes that the plan generally conforms to the EBL 2006; this Article does not say which articles or provisions of the EBL 2006 should be specifically complied with. In practice, all reorganization plans that are voted for by creditors are smoothly approved by the courts.

The contentious issue here might be that a reorganization plan that affects the equity of shareholders must, under the EBL 2006 Article 85, also be voted by shareholders.<sup>74</sup> Given the insolvency of most companies in reorganization, pursuant to Article 85, this means cancelling the previous equity must be agreed by the equity-holders. Professor Li Shuguang argues that if the company is financially insolvent, the vote of shareholders is advisory only and is not legally binding on the proposed

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<sup>73</sup> Chi Weihong, Lun Chongzhen Jihua De Zhiding [Making Corporate Reorganisation Proposals under the China Enterprise Bankruptcy Law of 2006], 3 Jiaoda Faxue [SJTU Law Review] 122, 131 (2017).

<sup>74</sup> Tang Weijian, Woguo Pochanfa Caoan Zai Chongzhen Chengxu Shiji Shang De Ruogan Zengyi Wenti Zhi Wojian [Several Problems of the Proposed Bill of Enterprise Bankruptcy Law on Reorganisation], 2 Faxue Jia [Jurists] 33, 36 (2005).



reorganization plan;<sup>75</sup> but the EBL 2006 is rather strict, requiring that the consensus of shareholders is needed. To solve potential deadlocks, if a reorganization plan failed in winning the vote of any class of creditors or the class of shareholders or both, under the EBL 2006 Article 87, it can still be submitted to the court for a forcible approval on the condition that the statutory tests are passed, which means, as noted before, that cram-down approvals are applicable under the EBL 2006.

Unlike under the USA Chapter 11 where cram-down mainly serves as a legal leverage to facilitate negotiations between stakeholders, the Chinese cram-down approval is often used to legitimize corporate reorganization plans that have been voted down by either creditors or shareholders or both; a study shows that cram-down approvals are used in around one quarter of the surveyed Chinese corporate reorganizations.<sup>76</sup>

Overall, reorganization is intended to be the primary corporate rescue procedure in China, though the harsh reality is that it is not widely available for troubled businesses to seek survival. An alternative rescue procedure is composition under the same EBL 2006.

#### *b. The Composition Procedure under the EBL 2006*

In theory, like the reorganization procedure embedded in the EBL 2006 Chapter 8, composition under Chapter 9 is also a rescue procedure.<sup>77</sup> If a settlement can be reached between the debtor and its creditors, the company can avoid being liquidated and survives the bankruptcy crisis.<sup>78</sup> Traditionally, composition is always favored by China's successive bankruptcy statutes, including the 1935 and 1986 bankruptcy laws. Compared with reorganization, which was applied, between 2007 and 2015, for some 700 companies,<sup>79</sup> composition is quite rarely used, since there are, during the same period, less than ten composition cases a year identified in China as a whole.<sup>80</sup>

*Composition applicants:* Under the EBL 2006 Article 95, a debtor may straightforwardly apply to the court to enter into a bankruptcy composition

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<sup>75</sup> Li Shuguang, *Zhongguo Xing Pochan Fa De Jige Zenyi Dian* [Some Issues on New Bankruptcy Law], 6 *Zhongguo Falu* [China Law] 17, 19 (2006).

<sup>76</sup> See note 34 above at chapter 6.

<sup>77</sup> Andrew Godwin, *Corporate Rescue in Asia – Trends and Challenges*, 34 *Sydney L. Rev.* 163, 180 (2012).

<sup>78</sup> Qinyu Zhang, *Composition in Enterprises Bankruptcy Law of China: Crises, Reflection and Reshaping*, 91 *Am. Bankr. L. J.* 55, 78 (2017).

<sup>79</sup> See note 34 above at chapter 2.

<sup>80</sup> These figures are collected by the author by examining the corporate bankruptcy advertisements published on the China People's Court Daily, a Chinese version of the law gazette.

procedure, and in the event of an existing liquidation, voluntary and involuntary, the debtor may ask the court to convert it into composition; in both situations, the debtor must accompany its application with a composition plan/proposal. But whether a composition procedure can be formally commenced depends on whether the court agrees with the debtor's application; the EBL 2006 Article 96 stipulates that if the court believes the application is in line with this law, again, without elaborating which provisions must be specifically conformed to, a court order may be issued to officially open a composition procedure.<sup>81</sup>

Logically, this equally means that if the court thinks the debtor's composition application does not comply with the EBL 2006 in general, the debtor's effort to use this procedure for bankruptcy relief will be rejected. To some extent, it is of opinion of the court whether a corporate bankruptcy composition procedure can be entered into. Given the widely perceived judicial irresponsibility of Chinese courts,<sup>82</sup> this is perhaps one of the major reasons why this bankruptcy procedure is virtually shelved to the detriment of the China business communities.<sup>83</sup> Except debtors, no other parties, including creditors or shareholders, can initiate a corporate composition procedure.

With the forty-six composition cases between 2007 and 2015 surveyed, it is found that thirty-six (78%) of them were converted from liquidations, i.e., these liquidations ended happily, since a composition plan was agreed by the debtor and its creditors prior to the completion of liquidations, so that liquidation was avoided. The remaining ten cases (22%) were filed originally as the composition procedure, which somewhat suggests that directly commencing a composition procedure might be more difficult.

*Control in compositions:* Although it is only the debtor who can propose a composition plan, the control of the company's assets and business affairs is, rather strangely, still in the hands of the court-appointed administrator. In the event that composition has been transformed from liquidation, the administrator previously appointed to manage the estate in the liquidation procedure will remain in office as the party in charge; for a directly-filed composition, under the EBL 2006 Article 13, the court will appoint a bankruptcy administrator to take control. It seems that, unlike in

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<sup>81</sup> Yujia Jiang, *The Curious Case of Inactive Bankruptcy Practice in China: A Comparative Study of US and Chinese Bankruptcy Law*, (2014) 34 Nw. J. Int'l L. & Bus. 559, 565.

<sup>82</sup> Terence C Halliday & Bruce G Carruthers, 'Institutional Lessons from Insolvency Reforms in East Asia' (The Fourth Forum on Asian Insolvency Law Reform 2004, 2-5 November 2004, New Delhi, India) 23.

<sup>83</sup> Zhang Qinyu, Pochan Hejie Zhi Shang [The Failure of the Bankruptcy Composition Regime under the EBL 2006], 1 Huadong Zhenfa Daxue Xuebao [Journal of East China University of Political Science and Law] 150, 151 (2014).

reorganization, debtor-in-possession is not available in a composition procedure.

It appears, however, paradoxical that, under the EBL 2006 Articles 13 and 95, on the one hand, the court-appointed administrator stays at the helm of the composition procedure, but that on the other, the composition plan, the key document in the procedure, can only be proposed by the debtor. Proposing a composition plan seems to be a substantial right in nature, which is not bestowed to the administrator, the party in charge. But in reality, given that most compositions are updated from liquidations, composition plans are more likely to be prepared by parties other than debtors instead. To clear up this doubt, fifteen compositions taking place between 2013 and 2015 are studied by searching more detailed information from publicly available sources, most of them media reports from China; there are five cases whose relevant information could be obtained.

Out of these five compositions, four of them were actually carried out as company sales, i.e., the creditors and the company buyer used a composition plan to conclude a sale under which the company as a going concern was sold to the buyer. Since in these four cases, the debtor behind which were the shareholders lost everything in the composition procedure, it was highly unlikely for the composition plan to have been proposed voluntarily. The most plausible explanation is that these composition plans were made by a coalition of the administrator, the major creditors and the company buyer. The debtor's right in proposing a composition plan might be significantly marginalized in reality.

In the remaining one case, in which the state-owned company, Puyang Plastics Limited, Henan Province, successfully used the bankruptcy composition procedure to solve its bankruptcy trouble in 2013, with the powerful support from the company's shareholder, a local government state-asset management department, the creditors accepted a debt reduction by voting for the composition plan.<sup>84</sup> Essentially, in this case, it was the local government that made the composition plan. Therefore, it seems safe to say that, concerning the control model, debtors are in a very weak position in composition procedures, mainly because it is unrealistic to translate debtors' right in proposing composition plans in books into the right in action.

*Composition plans:* A composition plan which does not bind secured creditors must, under the EBL 2006 Article 97, pass the vote of the unsecured creditors. It is unclear whether unsecured creditors should be, like in reorganization under the EBL 2006 Article 82, divided into three

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<sup>84</sup> Puyang Human Resources Net, 'The Puyang Municipal Government Reforms State-Owned Companies through Injecting Capital' (20 April 2015, Puyang Henan China) 1.

classes as employee, tax and ordinary unsecured creditors to vote on a composition plan. But bearing in mind that most composition plans fully honor employee and tax authority claims, perhaps, only ordinary unsecured creditors are to vote.

It is worth noting that under the EBL 2006 Article 96, as stated above, a composition plan does not bind secured creditors, and that this Article makes it crystal clear that a secured creditor is exempt from the general moratorium, which means that in a composition procedure, a secured creditor can realize encumbered assets without regard to the rescue procedure. Some comment that this would make composition less effective in rescuing troubled companies.<sup>85</sup> However, this concern might be considerably alleviated in real cases, since most compositions are transferred from liquidations in which a previous general moratorium automatically imposed in liquidation has already prohibited the foreclosure of securities.<sup>86</sup>

Similar to a reorganization plan, a composition plan also needs to go through two stages before taking effect. First, under the EBL 2006 Article 97, it must be voted in favor by over half of attending unsecured creditors holding over two-thirds of the entire unsecured claims; failing in winning the vote of unsecured creditors, the composition effort is doomed, and, under the EBL 2006 Article 99, will be converted into liquidation. Having gained the consent from the unsecured creditors, under Article 98, the passed composition plan must be ultimately recognized or approved by the court; again, this Article does not say how the court will assess the voted composition plan before giving the blessing.

An approved composition plan must be executed by the debtor company under the EBL 2006 Article 102, which essentially means that the debtor will pay the unsecured creditors as promised in the composition plan. In the light of the prevalence of company sale compositions, the post-composition debtor might have been largely transformed, since the rehabilitated debtor is usually under the new ownership of the company buyer. Under the EBL 2006 Article 104, in the event that the debtor is unable to, or does not, fulfil its obligations under the approved composition plan, the court may, at the request of composition creditors, terminate the execution of the composition plan and directs it into liquidation straightforwardly; this did happen.<sup>87</sup>

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<sup>85</sup> See note 78 above.

<sup>86</sup> The EBL 2006 Article 19.

<sup>87</sup> Shuyang County People's Court, Gonggao [Public Notice on the Termination of the Composition Procedure of Aufama Vitamin Limited], Renmin Fayuan Bao [The China People's Court Daily] Oct. 31, 2015, 3.

To sum up, composition is scarcely used in practice, mainly because of the judicial inactivity; most existing compositions are converted from liquidations. Presumably, in these liquidations, if a serious buyer emerges, converting liquidation into composition would be an effective way to sustain the company as a legal entity, since liquidation exclusively leads to the dissolution of the company. Maintaining the debtor company as a legal entity makes sense in China, for most business licenses will be revoked by regulators if the company as a legal person is dissolved.<sup>88</sup> In contrast with reorganizations and compositions, liquidation is undoubtedly the most used bankruptcy procedure in China.

*c. The Liquidation Procedure under the EBL 2006*

It seems to be an irony that liquidation, the paramount bankruptcy procedure by number at least, is arranged at the third place in the bankruptcy choice ladder under the EBL 2006. Nevertheless, its significance cannot be simply judged over its position in the statutory order. Between 2007 and 2015, an eight-year period, there were some 27,345 corporate bankruptcy cases dealt with in China as a whole, 26,371 (96%) of them liquidations.<sup>89</sup>

*Liquidation applicants:* under the EBL 2006 Article 10, both the debtor and its creditor, in theory, can file to the local court to open a liquidation procedure; a single creditor could trigger a liquidation against the debtor, whereas in the USA, usually there should be at least three creditors acting jointly to bring a debtor into a liquidation procedure.<sup>90</sup> In contrast to the UK insolvency law under which a wide range of parties, including the debtor, its directors, creditors and contributories, can initiate a liquidation case,<sup>91</sup> such a right in China is only reserved for the debtor and its creditors.

For a voluntary liquidation filing, under the EBL 2006 Articles 2 and 7, the debtor must present the evidence to pass both the cash-flow and balance-sheet bankruptcy tests. In practice, to meet this requirement, the company usually provides an audited financial report to convince the court. In contrast, in the USA, a voluntary liquidation application does not need to show the evidence of the company's insolvency at all.<sup>92</sup> The concept of bankruptcy relief has not yet been established in China.

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<sup>88</sup> Xianchu Zhang & Charles D Booth, *Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience*, 15 Colum. J. Asian L. 1, 23 (2001).

<sup>89</sup> The number of annual corporate bankruptcies is from the China Annual Law Year Books and the China Supreme People's Court Annual Reports.

<sup>90</sup> 11 USC § 303 (a).

<sup>91</sup> Insolvency Act 1986 s 124.

<sup>92</sup> 11 USC § 301.

With respect to an involuntary liquidation application, it looks easier, since the EBL 2006 Article 7 only requires the filing creditor to prove the company's cash-flow bankruptcy, i.e., the debtor is unable to pay the debt that is due. In reality, however, it can be frequently identified that many Chinese courts still require filing creditors to prove that the debtor company is bankrupt by both the cash-flow and balance-sheet test.<sup>93</sup>

Although on the fact of it, a liquidation procedure can be initiated very conveniently by relying on the aforementioned Articles, the law in action is, to a large extent, different. Most, if not all, Chinese courts turn a blind eye to corporate liquidation filings; even some local courts, for example, have not accepted one single corporate liquidation during the first eight-year period following the implementation of the EBL 2006 since 2007.<sup>94</sup> And one study estimates that in China, only less than one per cent of bankrupt companies that are supposed to be placed in judicial bankruptcy procedures could access the formal liquidation procedure to exit the market.<sup>95</sup>

To be realistic, to initiate a corporate liquidation procedure, as well as reorganization and composition, in China, the political support from local government is the key condition prior to the local court considering the application. Even it is not an exaggeration to say that the whole judicial system does not respond to businesses on bankruptcy issues; rather local courts only open liquidation procedures at the request of local government.<sup>96</sup> Therefore, to a great extent, local government is the only eligible party to initiate a judicial company liquidation procedure mainly for political reasons; it sounds rather abnormal, but it is the reality in the country.<sup>97</sup>

*Control of Liquidations:* Under the EBL 2006 Articles 13 and 25, a bankruptcy administrator, the liquidator, will be immediately installed by the court to take possession of the company's properties and business

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<sup>93</sup> The Shenzhen Municipal Intermediate People's Court, Gonggao [The Public Notice on the Liquidation of Shenzhen Bao'an Bicycle Limited], Renmin Fayuan Bao [The China People's Court Daily] Oct. 1, 2014, 3.

<sup>94</sup> The Shandong Province Supreme People's Court, Quanshen Fayuan Pochan Anjian Taishi Fengxi Ji Duice Jiangyi [Corporate Bankruptcy Cases in Shandong Province: Trend and Suggestions], 3 Shandong Shenpan [Shandong Justice] 17, 18 (2015).

<sup>95</sup> Zinian Zhang & Roman Tomasic, *Corporate Reorganisation Reform in China: Findings from an Empirical Study in Zhejiang*, 11 Asian J. Comp. L. 58, 68 (2016).

<sup>96</sup> The China Supreme People's Court, Guanyu Zhenque Shenli Qiye Pochan Anjian Wei Weihu Shichang Jingji Chixu Tigong Sifa Baozhang Ruogan Wenti De Yijian [Several Suggestions of Dealing with Company Bankruptcies to Strengthen Chinese Market Economy], 36, Jun. 12, 2009, 8.

<sup>97</sup> The People's Bank of China and the Wenzhou Municipal Government, 'The Government's Role in Corporate Bankruptcies' (Working Paper of Tsinghua University, 23 June 2016) 9-10.

affairs; in fact, the company as a whole will be managed by the administrator in the entire course of liquidation. However, the liquidation administrator must be heavily supervised by the court. For example, under the EBL 2006 Article 26, to decide whether the company's business operation should be terminated, the administrator must get the permission from the court; such supervision seems unjustifiable, for even some judges lament that whether to keep the company's business operation on is a commercial, rather than legal, assessment, and that judges are not professionally fit to do this job.<sup>98</sup>

Meanwhile, under the EBL 2006 Article 69, before disposing of the company's substantial assets, including, among others, land, buildings, and intellectual properties, the administrator must get the advance permission either from the court or from the creditors committee; bearing in mind the creditors committee is rarely formed,<sup>99</sup> asking for the permission from the court is the condition before the administrator taking action to deal with the company's key assets. This leads to some commenting that bankruptcy administrators in China somewhat act as the assistants of judges in corporate liquidations.<sup>100</sup> Hence, corporate liquidations in China are heavily court-controlled in real terms.

*Value Distribution in Liquidations:* After realizing the company's assets, the bankruptcy administrator, under the EBL 2006 Article 115, must prepare a value distribution plan, which is to be voted at the meeting of creditors and needs to be confirmed by the court afterwards. Pursuant to the EBL 2006 Article 64, the value distribution plan is passed if it is voted in favor by over half of attending creditors in number whose claims represent over half of the unsecured debts in value. Compared with the passage of a corporate reorganization plan that needs the support of creditors over half in number and over two-thirds in claims,<sup>101</sup> the threshold of passing a liquidation value distribution plan seems to be easier to cross.

Concerning the priority of distributing the value of the company between various parties, the EBL 2006 Article 113 creates a payment hierarchy according to which after meeting liquidation costs, including the

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<sup>98</sup> The Second Civil Chamber of Pujiang County People's Court, Zhejiang Province, 'Sustain Economic Growth and Maintain Social Stability: Experience in Dealing with Corporate Bankruptcies in Pujiang' (Working paper prepared by the Pujiang Court in an internal seminar organized by the Zhejiang Province Supreme People's Court) (on file with author) 89.

<sup>99</sup> Yu Lin, Pochan Chenxu Zhong Guanli Ren Zhize Luxing De Qianghua Yu Jiangdu Wanshan [*Supervision of Corporate Bankruptcy Administrators in China*], 15 Falu Shiyun [Journal of Law Application] 37, 45 (2017).

<sup>100</sup> Jingheng Law Firm, 'Eight Lawyers from Jingheng Attended the Insolvency Practitioner Conference' (Hangzhou Zhejiang China, 18 September 2011) 1.

<sup>101</sup> The EBL 2006 Article 84.

administrator's fees, liquidation expenses and post-liquidation debts, the value of the company goes to paying employees at first, followed by tax claims and, in the case of a surplus, pays ordinary unsecured creditors, and if any of these three classes of unsecured creditors could not be paid in full, *pari passu* applies. The question here is that, in view of the fact how to distribute the value of a company in liquidation has been clearly regulated by the law, why the value distribution plan still needs the approval, a second assessment, of creditors. In the UK, the liquidator only needs to report the value distribution issues to the meeting of creditors, and no vote of creditors on this is required;<sup>102</sup> in the USA, a Chapter 7 liquidation trustee is to distribute the value of the estate to creditors under the law, and no vote of creditors is held.<sup>103</sup> The absurdity of China's EBL 2006 on this should be rethought.

The most contentious over value distribution appears to be the priority between employees and secured creditors in China.<sup>104</sup> Under the EBL 2006 Articles 109 and 113, it is a general principle for secured assets to be sold to meet secured claims first, but the EBL 2006 Article 132 makes an exception that employee claims generated before the EBL 2006 taking effect, namely, 1<sup>st</sup> June 2007, should be paid ahead of secured creditors. Some historic context should be explained here for a better understanding.

Under the old EBL 1986 Article 28, secured creditors are paid from realizing secured assets and are technically ranked before employees; but this principle is later undermined by an executive notice entitled 'The Policies on the Bankruptcy of SOEs in the Selected Cities' issued by the China State Council, the Chinese central government, in 1994,<sup>105</sup> which reverses the statutory priority between secured creditors and employees in the bankruptcies of SOEs that are located in eighteen cities designated by the State Council as the national SOE bankruptcy experimental areas. Strictly speaking, the priority of securities is still retained in the bankruptcy of SOEs that are not from these selected eighteen cities; of course, in the bankruptcy of private companies, securities must be absolutely respected, at least in theory.

Unfortunately, the 1994 notice was frequently abused by local governments to use the money of secured creditors, almost all of them

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<sup>102</sup> Insolvency Act 1986 s 99.

<sup>103</sup> 11 USC § 726.

<sup>104</sup> Chen Xiahong, Cong Hexing Dao Bianyuan: Zhongguo Pochan Lifa Jinghua Zhong De Zhigong Wenti [Fading Preference: Employee Protection in Chinese Bankruptcy Laws from 1986 to 2016], 4 Gansu Zhenfa Xueyuan Xuebao [Journal of Gansu Political Science and Law Institute] 92 (2016).

<sup>105</sup> The China State Council, Guanyu Zai Ruogan Chenshi Shixing Guoyou Qiye Pochan Youguan Wenti De Tongzhi [Policies on the Bankruptcy of SOEs in Selected Cities] 1994-59, Oct. 25, 1994.



central-government-owned banks, to resettle the employees of troubled local SOEs, whether these SOEs are from the eighteen chosen cities or not.<sup>106</sup> Five years later, in 1999, the Chinese central government succumbed to the demands of local governments, in a new policy notice, allowing employee claims to be paid before securities in the bankruptcy of all SOEs, wherever they are from.<sup>107</sup> The priority of employees over secured creditors is widely practiced in the bankruptcy of SOEs in China, but is unlawful, since it is against both the spirit and letters of the EBL 1986, and inevitably it invited much criticism.<sup>108</sup>

The EBL 2006 seems to have somewhat legalized and expanded such a priority on two fronts, however. First, its Article 133 elevates and reaffirms the successive policies on the bankruptcy of SOEs issued by the China State Council, maintaining that the bankruptcy of SOEs is subject to the policies issued by the State Council, which solves the legal conflict between the old EBL 1986 and the aforementioned executive notices. In substance, this Article reassures that in the bankruptcy of SOEs, the priority of employees over secured creditors is retained and continues to apply, before and after the promulgation of the EBL 2006. Second, rather than exclusively prioritizing employees over secured creditors in the bankruptcy of SOEs under the old regulations, the EBL 2006 Article 132 expands such a priority to the bankruptcy of all non-SOE enterprises, but only favors the employee claims accumulated before the EBL 2006 came into force on 1 June 2006.

Obviously, it is a political concession made during the making of the EBL 2006.<sup>109</sup> But it is worth noting that respecting securities in corporate bankruptcies in China is a norm, and in only exceptional occasions, securities are to give way to employees.

After using the value generated from selling the company's assets, tangible and intangible, to pay creditors, the liquidation administrator will inform the company registration authorities to remove the company from the official company list. But in practice, this is not easy. The China Tax Management Law 2001 Article 16 requires that a company could not be deregistered if there is unpaid tax. Given that in many company

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<sup>106</sup> The China State Council, *Guanyu Zai Ruogan Chenshi Shixing Guoyou Qiye Jianbing Pochan He Zhigong Zai Jiuye Youguan Wenti De Buchong Tongzhi* [Additional Notice on Mergers and Bankruptcies of SOEs in the Selected Trial Cities], Mar. 2, 1997.

<sup>107</sup> The China National Economy and Trade Commission and the People's Bank of China, *Guanyu 1999 Nian Quanguo Qiye Jianbing Pochan Gongzuo Youguan Wenti De Tongzhi* [The Notice on Several Issues of SOE Mergers and Bankruptcies], Apr. 16, 1999.

<sup>108</sup> Liu Sixuan, *On the Judicial Responses to Policies – Based on the Examples of the Chinese Enterprise Reform Policies since 1979*, 4 *Journal of Social Sciences* 98, 99-100 (2012).

<sup>109</sup> Terence C Halliday, 'The Making of China's Corporate Bankruptcy Law' (The Foundation for Law, Justice and Society) 3.

bankruptcies, tax authorities could not be fully repaid; usually the company registration authority simply refuses to delete the company's name from the official list.<sup>110</sup>

## V. CONCLUSION

Although China enacted much-awaited EBL 2006, its implementation remains considerably weak. Only a meagre proportion of bankrupt companies could access bankruptcy procedures under the new law to exit the market. In spite of the creation of the new rescue-friendly reorganization procedure in this law, the overwhelming majority of existing bankruptcies are liquidations. Another rescue procedure, composition, is almost forgotten in judicial practice, since only less than fifty cases between 2007 and 2015 are identified.

In general, regarding the legislative objective in promoting a corporate rescue culture in China, apparently, given that the new rescue procedure is only occasionally used at the request of local government to rehabilitate large local companies and that most pro-rescue legislative innovations are not really used, it is perhaps difficult to say that this objective has been achieved. Meanwhile, in view of a small number of bankruptcy cases handled in China annually, there are indeed few cases for the newly qualified insolvency practitioners to practice and to improve their skills and expertise, so that the mission of establishing a well-functioning insolvency profession also cannot be said a success. In addition, the goal of facilitating international cooperation on cross-border corporate insolvencies seems to be a total failure, as Chinese law courts have not yet relied on the new recognition procedure to assist any foreign insolvency office holders. The implementation of the EBL 2006 in the past ten years is largely a fiasco.

Arguably, as for the way forward, the current court-centered bankruptcy system should be overhauled, and a market-based bankruptcy regime, mainly relying on the work of insolvency practitioners, including lawyers and accountants, might be the future if China does need an effective bankruptcy system. It should be addressed that the Chinese ruling class, including governments and courts, does not need a corporate bankruptcy law, but the China business community comprising creditors and debtors desperately crave for an effective and efficient bankruptcy law so as to either seek fairness or look for relief.

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<sup>110</sup> Wang Xinxin, *Jiangshi Qiye Zhili Yu Pochan Fa De Shishi* [Handling Zombie Companies and Implementing the Enterprise Bankruptcy Law], 13 *Renmin Sifa* [People's Judicature] 4, 9 (2016).

At the moment, the only hope would be that the international communities, especially the USA and the EU, keep on imposing pressure on China for legal reform; expecting China's internal forces to reform its legal system in general and the bankruptcy system in particular, it seems, is more likely to be met with disappointment.