

Consideration of Corporate Governance in Draft Bankruptcy Law of China

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Introduction

Modern insolvency law and corporation law are close brothers. The rules of insolvency law that operate as a set of incentives and constraints to influence company directors' behavior should be taken into account by both insolvency and corporation lawyers. "Directorial accountability can operate through a variety of devices . . . but the purposes to be served by such devices may also vary. Insolvency law, for instance, might set out to punish an errant director; to protect creditors at risk from directorial actions; to compensate parties who have suffered losses at the hands of directors; and insolvency law and company law may also seek to achieve a number of other ends such as raising standards of business conduct and entrepreneurship."¹

A search for the purposes underlying current corporate insolvency law controls over directors can begin with the Cork Report.² Cork indicated that the function of insolvency law was not only to distribute the insolvency estate to creditors, but also to encourage debt recovery and, through investigations and disciplinary actions, to meet "the demands of commercial morality".³ Central here, then, was the notion that insolvency law and investigative processes would uncover assets concealed from creditors, ascertain the validity of creditors' claims, and expose the circumstances surrounding the debtor's failure. Cork, thus, emphasised the need for insolvency law to promote the "highest standards of business probity and competence".⁴

In China, the relevant provision on this account first appeared in the 1986 Enterprise Bankruptcy Law, reading as the following:

Article 42 After an enterprise is declared bankrupt, the government supervisory departments and audit departments are responsible for pinpointing the responsibility for the bankruptcy of the enterprise.

Where the legal representative of the bankrupt enterprise bears the major responsibility for the bankruptcy of the enterprise, administrative sanctions shall be applied.

Where the superior departments in charge of the bankrupt enterprise bear the major responsibility for the

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¹ Vanessa Finch, *Corporate Insolvency Law: Perspectives and Principles*, Cambridge University Press, 2002, p.495.

² *Report of the Review Committee on Insolvency Law and Practice* (Cmnd 8558, 1982) ('Cork Report').

³ Cork Report, para. 235.

⁴ See, also, Vanessa Finch, *Ibid.*, p.496.

bankruptcy of the enterprise, administrative sanctions shall be applied to the leaders of such superior departments in charge.

During the past years, this rule was not well enforced. The main reason was that most SOEs had long been insolvent before being filed in bankruptcy proceedings and the elements contributory to the financial distress of SOEs were very complicated. On the other hand, the bankruptcy procedure lacked sufficient means to deal with the pre-petition conducts of the management.

In 1994-95, when the new bankruptcy legislation was under drafting, the stipulation of this kind was ignored. At that time the focus of the drafting work in this regard was on the fraudulent transactions and other illegal conducts during or prior to the proceeding, aiming at the order of collective satisfaction.

In 2000 when the drafting work started again, more attention was paid on corporate governance and protection of financial stability.⁵ In many occasions when the new law was under discussion, corporate governance was taken into account seriously. In the 2000 Draft the rule on investigating the responsibility of management for failure of the insolvent firm was restored.⁶ In the meantime, some rules related to corporate governance were stressed on in the subsequent drafts.

Since 2000 the draft has come through several revisions. The up-to-date draft was made in November 2003 by the drafting committee under the leadership of the Fiscal and Economic Commission, the 10th National People's Congress. In this draft, that has been distributed nationwide to collect comments, the articles relevant to corporate governance could be categorized in two parts: first, restriction to managerial behavior during the procedure, and second, investigation of conducts prior to the procedure.

I. Restriction to Managerial Behavior During the Procedure

1. *Take-over*. The draft set up an office of administrator who is designated when the court accepts the insolvency case. One of the major functions of administrator is to take over the assets and business of the debtor.⁷ In order to insure this function, some duties are imposed on the managerial persons:

Article 21 The debtor and relevant persons shall bear the following obligations from the date when the people's court accepts the insolvency case:

⁵ See, Wang Weiguo, "On Several Aims in Drafting the New Bankruptcy Law", *Tribune of Political Science and Law*, No.3, Vol.20 (June 2003). This paper is based on the author's speech at the International Conference on Corporate Insolvency and Reorganization in July 2000. The author indicates:

"It is an important task of enacting new bankruptcy law to advance and safeguard the SOE reform. . . . The fundamental objective of SOE reformation is establishment of modern company system, and one of the major issue in this system is corporate governance. The new bankruptcy law shall play a role in bestirring and spurring on the corporate managements and shall not leave chance for the scrimshankers and badger hats to betake themselves to their heels via bankruptcy."

⁶ Article 156 of the 2000 Draft reads:

If the directors, managers and other administrative personnel of an enterprise render the enterprise bankrupt due to their negligence or deliberation, they shall be imposed a fine of more than RMB 50,000. If the acts constitute crimes, criminal responsibilities shall be investigated in accordance with the laws.

The personnel punished under the preceding paragraph shall be prohibited from engaging in operation and management affairs of an enterprise within 10 years after the close of insolvency case.

⁷ Article 25 reads: "The administrator shall take over the debtor's all property from the date appointed by the people's court."

(1) Appropriately keeping all the property, accounting books, documents, data, seals and other articles that are occupied, used and managed by them;

(2) Working according to the requirements of the people's court, the administrator and the reorganization executor and answering the inquiries with honest;

(3) Attending the creditors' meeting as nonvoting delegates and answering the creditors' inquiries with honest;

(4) Not leaving the place of domicile without the authorization of the people's court.

The relevant persons referred to in the preceding paragraph include representatives of enterprise legal persons, partners and chief officers of partnership enterprises, investors and chief officers of sole-proprietorship enterprises or principals of other profit-making entities; if necessary and the people's court so decides, financial officers and key business executors of an enterprise may be included.

2. *Business operation.* In case that reorganization proceeding is applied, the managerial personnel could be authorized to carry out business operation. The Draft provides:

Article 71 During the protective period of reorganization, the administrator may appoint the managerial personnel of the enterprise to preside over its business operation.” Obviously, the business authorization is subject to supervision of administrator.

In the recent discussion among the drafting experts, a suggestion that the former managements would be more active in business running, just comparable to the concept of “debtor in possession” in American bankruptcy law, was appreciated by some participants. On the other hand, it is still an apprehension that the problem of “moral hazard” of the managements could not be despised. Even if under the provision of Article 71 this problem does exist.

One of the restrictive measures over the managerial persons in the Draft is the exit of reorganization that leads to bankruptcy liquidation, as stipulated in the following.

Article 77 During the protective period of reorganization, upon the request of interested parties, the people's court may decide to terminate the reorganization procedure after examination and confirmation:

(1) If the management and financial situation of the debtor continue to be deteriorating and there is a lack of possibility to save it;

(2) If the debtor acts with fraud, decreasing the enterprise's property in bad means, delaying without reasons or other behaviors that apparently are disadvantageous to the creditors;

(3) If the behaviors of the debtor's institution or other employees make the administrator unable to perform his duty.

Where the reorganization plan has not been approved upon the expiration of the protective period of reorganization, the people's court shall decide to terminate the reorganization procedure ex officio.

Under the circumstances prescribed in the preceding two paragraphs, the people's court shall meanwhile make a ruling to declare the debtor bankrupt.

3. *Sanctions.* Some relative sanctions are given in the Chapter 9 on “Legal Responsibilities” against those who violate the above-mentioned restrictions. There are two illustrations below.

Article 150 Debtors or debtor's representatives, who are obliged to be present at the creditors' meeting yet absent from the meeting without justifiable reasons in spite of the summon from the people's court, shall be arrested and taken into custody by the people's court and shall be subject to an administrative fine of over RMB 5,000 but below RMB 50,000. Debtors and other personnel responsible to make accounts or give explanations, or even make false accounts or explanations, shall be subject to an administrative fine of over RMB 5,000 but below RMB 50,000 by the people's court. Where such misconduct constitutes crimes, criminal responsibilities shall be investigated in accordance with the law.

Article 151 Where the debtor, in violation of the provisions of this Law, refuses to submit the specification on his financial status, the detailed list of debts, the detailed list of credits and related financial report to the people's court, or submit unreal documents, the people's court may impose a fine ranging from

over RMB 5,000 to under RMB 50,000 upon the person directly responsible for the conditions.

Where the debtor, in violation of the provisions of this Law, refuses to transfer the property or the accounting books, documents, material, data, seals related to the property to the administrator or the bankrupt liquidator, or the debtor counterfeits, destroys some evidence related to the property, resulting in the ambiguity of the property status, the people's court may impose a fine ranging from over RMB 10,000 to under RMB 50,000 upon the person directly responsible for the conditions.

Where any person acts as prescribed in the preceding two paragraphs and constitutes crimes, criminal responsibilities shall be investigated in accordance with the law.

II. Investigation of Conducts Prior to the Procedure

1. *Exposing debtor's business failure.* There was a strong voice in the drafting process asking for investigating the liability of managements for the business failure that led to the bankruptcy. In the up-to-date text, the wording has something different from the 2000 Draft, that is, the liability must contain the factor of "gross" negligence or intentional offence. It means that slight negligence shall not be responsible.

Article 149 Where the directors, managers and other personnel of the bankrupt enterprise, owing to gross negligence or intentional offense, bear major responsibility for the bankruptcy of the bankrupt enterprise, the person involved shall take joint repayment liability; where their misconduct constitutes crimes, criminal responsibility shall be investigated in accordance with relevant laws of the state. Personnel subject to above mentioned penalties shall be restricted from any business operations or business management within 5 years following the conclusion of the bankruptcy proceedings.

This could be deemed as a positive response to the suggested principle by the World Bank that "[l]aws governing director and officer liability for decisions detrimental to creditors made when an enterprise is in financial distress or insolvent should promote responsible corporate behavior while fostering reasonable risk taking. At a minimum, standards should hold management accountable for harm to creditors resulting from willful, reckless or grossly negligent conduct."⁸

It is deferent from Article 42 of the 1986 Enterprise Bankruptcy Law that in this new article criminal punishment and sanction of disqualification are adopted. This is based on the consideration of strengthening discipline on the managements.

2. *Avoidance of pre-commencement transactions and transfers.* UNCITRAL suggests: "Many laws regard some transactions executed prior to the initiation of an insolvency proceeding as unfair or financially harmful to the interests of all of the debtor's stakeholders, especially if they are executed in contemplation of a likely insolvency. A transaction may fall into this category retrospectively—that is, it may be a transaction that would not ordinarily be regarded as legally wrongful, but is seen as harmful in light of a subsequent insolvency."⁹ In most of the insolvency cases in China, debtors had long been insolvent before commencement of the proceedings, and the managements thereof had plenty of time to conceal or transfer the property for themselves or their related persons to the effect of prejudicing of the general body of creditors. This is a quite common

⁸ The World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems* (2003), No.6.

⁹ United Nations Commission on International Trade Law, *Draft Legislative Guide on Insolvency Law: Report of the Secretary-General* (2001), para.119.

phenomenon worldwide, just as IMF indicates that “[a] debtor may enter or be placed into insolvency proceedings days, weeks, months, or sometimes years after recognizing that this outcome is inevitable. In anticipation of the formal commencement of insolvency proceedings, therefore, debtors may deviate from their ordinary business practices by attempting to hide assets from their creditors, incurring artificial liabilities, favoring certain creditors over others, or making donations to relatives or friends.”¹⁰ China’s existing Enterprise Bankruptcy Law sets forth a mechanism that recaptures assets whose transfer prior to the commencement of the proceedings has such a detrimental effect as the following:

Article 35 During the period from six months before the people’s court accepts the insolvency case until the date that bankruptcy is declared, the following actions of a bankrupt enterprise are null and void:

- (1) concealment, secret distributions or transfers of property without compensation;
- (2) sale of property at abnormally depressed prices;
- (3) securing with property claims that originally were not secured with property;
- (4) early repayment of claims that are not yet due; and
- (5) abandonment of the enterprise’s own claims.

With respect to bankrupt enterprises which have committed acts listed in the previous paragraphs, the liquidation team has the right to apply to the people’s court to recover the property, which shall be added to the bankruptcy property.

As shown in the practice, this provision has two shortcomings. First, the period from six months before acceptance of the case is too short. Second, the unfair favorite payment prior to the proceeding is ignored. UNCITRAL advises: “Four common types of avoidable transactions are found in most legal systems. They are: transfers intended to defraud creditors, transfers at an undervalue, preferential payments to certain creditors, and invalid security interests.” “Some insolvency laws explicitly specify the suspect period (for example, so many days or months before commencement of insolvency) during which each of these types of transactions would be subject to avoidance. . . . Some systems may have one suspect period for all types of avoidable transactions, while others have different periods depending upon factors such as whether the injury to creditors was intentional, whether the transferee was an insider (i.e. a person who has a close corporate or family relation to the debtor or its creditors). Because fraudulent transactions involve intentionally wrongful conduct, substantial suspect periods, which might be anything from one to six years, are often fixed.”¹¹ The draft new law provides 3 articles to cope with these transactions:

Article 33 Within one year before the people’s court accepts the insolvency case, the administrator is entitled to request the people’s court to rescind the following activities taken by the debtor concerning the debtor’s property and property rights:

- (1) Transferring property or property rights free of charge;
- (2) Transferring property with obviously unreasonable low prices;
- (3) Providing property security for the debts that originally have no property security;
- (4) Paying off in advance the undue debt;
- (5) Giving up credits;
- (6) Other activities that impair the interests of the creditors.

Article 34 Within six months before the people’s court accepts the insolvency case and upon full knowledge of his inability to pay off due debts, where the debtor still pays off debts to specific creditors,

¹⁰ IMF Legal Department, *Orderly & Effective Insolvency Procedures: Key Issues* (1999).

¹¹ United Nations Commission on International Trade Law, *Draft Legislative Guide on Insolvency Law: Report of the Secretary-General* (2001), para.122, 124.

which impairs the interests of other creditors, the administrator is entitled to request the people's court to rescind the repayment unless the specific repayment benefits the bankrupt property.

Article 35 The following activities taken by the debtor concerning the property and property rights of the debtor shall be invalid whenever they occur:

- (1) Hiding, illegally distributing property;
- (2) Fabricating debts or recognizing unreal debts.

The most severe frauds contained in Article 35 shall be absolutely void without time limitation. The other fraudulent transactions in Article 33 are treated avoidable with suspect period in one year before acceptance.¹² Article 34 dealing with unfair favoritism seems quite gentle, with only six months of suspect period and some exceptional case added. Corresponding to these differences, punishments against violations are given distinctively as the following:

Article 152 Where the debtor acts as prescribed in the provisions of Article 35 of this Law, the people's court may impose a fine ranging from over RMB 20,000 to below RMB 100,000 upon the person directly responsible for the misconduct. Where such misconduct constitutes crimes, criminal responsibilities shall be investigated in accordance with the law.

Article 153 Where the debtor acts as prescribed in the provisions of Article 33 and Article 34 of this Law, the people's court may impose a fine ranging from over RMB 10,000 to below RMB 50,000 upon the person directly responsible for the misconduct. Where such misconduct constitutes crimes, criminal responsibilities shall be investigated in accordance with the law.

In comparison with the provision in Article 41 of the existing Enterprise Bankruptcy Law,¹³ the punishment in the Draft is much more clear and workable. By way of illustration, "administrative sanctions" in Article 41 are decided by government. In the past years, the real happening is rare. It is hardly to expect that government agencies will be involved in bankruptcy proceedings. Moreover they are also hardly justified to impose administrative sanctions on managements of companies with non-State investment. The proper solution should be shift the sanction power from governments to the courts.

In addition to right to rescind or avoid the transactions prescribed in Articles 33, 34 and 35, right to recover the property so transferred is granted to administrator, who is appointed at the time of the court's acceptance of the case, with the functions of take-over and management over the debtor's assets.¹⁴

3. *Further recovery of property abnormally obtained by the management.* During the drafting process some people urged to establish a rule dealing with such situation that the managements got enrichment or indulged in dissipation even though their enterprises had long been distressed. In response to this appeal some particular stipulations are given in the Draft.

¹² The suspect period for such circumstances as specified in this Article was originally six month in the 1995 Draft and then became one year in the 2000 Draft.

¹³ Article 41 of the Enterprise Bankruptcy Law reads: "With respect to bankrupt enterprises that have committed any of the acts listed in Article 35 of this Law, the legal representative and the directly responsible personnel of the bankrupt enterprise shall be subject to administrative sanctions; where the acts of the legal representative and the directly responsible personnel of the bankrupt enterprise constitute crimes, criminal responsibility shall be investigated in accordance with the law."

¹⁴ Article 36 reads: "The administrator is entitled to recover the debtor's property or property rights that are obtained through activities stipulated in Article 33, Article 34 or Article 35 of this Law."

Article 38 The administrator shall recover the abnormal income that the directors, managers and other principals of the bankrupt enterprise have obtained by taking advantages of their official authority and the enterprise's property that they encroach in the same manner.

Article 154 Where the debtor has known or should have known his inability to pay off his due debts, but still makes irrational or extravagant expenses, the people's court may impose a fine ranging from over RMB 10,000 to below RMB 50,000 upon the person directly responsible for the action. Where such misconduct constitutes crimes, criminal responsibilities shall be investigated in accordance with the law.

III. Conclusions

It is expectable that when the new Bankruptcy Law is promulgated and well enforced, it will play a positive role in improving corporate governance in China. First, when anticipating the legal effect of their conduct under the bankruptcy procedure, they shall have incentive to operate business with greater care, either fighting against financial difficulties or avoiding fraudulent transactions. Second, realizing the risk of possible investigation and legal punishment provided in the new Law, they shall have less courage to take advantage of bankruptcy for weaseling from liabilities, so that they must meliorate their manner in carrying out their managerial functions.

In fact, bankruptcy law is a potential mechanism of outer supervision. Since the key issue of corporate governance is transparency or information disclosure, bankruptcy procedure provides creditors the power of supervision under the circumstances of corporate insolvency. Importantly, this power is exercised in a collective way and supported by the judicial authority and some professional agencies. This should be a strong force to spur the managements to work in higher loyalty and diligence.

To some extent, there are two basic problems related to corporate governance. The first one is so-called "soft budget constraint". Where there is opportunity to shift risk and losses to outsiders, e.g. creditors or consumers, the insiders of a company are willing to act wildly against legal and moral norms. The second one is the unbalance of information between the insiders and outsiders. Since the outsiders have insufficient information concerning the risk/loss shift, the insiders have much higher probability to win the game. This may further encourage the insiders to go ahead in such shifting. In ordinary situation the outsiders are not entitled to look into the inside of a company so that they have no means to get sufficient information. When bankruptcy procedure is applied, however, the situation is different -- almost all the information will be open to the creditors or the administrator who bears the function to protect creditors' interests. As long as there is a mechanism to investigate and punish the misconducts, anticipation of this result will conduce to "hard budget constraint" in a company and therefore to restrict the "moral hazard" of the inner controllers.