

Bankruptcy Law Reform in China

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Introduction

This short essay will address two aspects regarding Chinese bankruptcy law reform. One aspect involves the New Draft Bankruptcy Law (2002 Draft) and the other concerns the New Rules on Hearing Bankruptcy Cases recently promulgated by the Supreme People's Court of China.

In China, the reform of bankruptcy law has been put on the national legislative schedules since 1994 to accommodate China's transition from command economy to market economy. In 1995 a comprehensive draft of the uniform bankruptcy law containing 10 chapters and 193 articles was completed and proposed to the higher authority for consideration, but was unluckily shelved for a long time due to unripe social and legal conditions. The drafting process resumed in 1998 and is now under the progress.

The latest edition of the draft is the 2002 Draft entitled "The Enterprise Bankruptcy and Reorganization Law of the PRC". This Draft was mainly based on 2001 Draft proposed by the drafting group and was discussed among academics, government officials and practitioners in early this year. Many articles of 2002 Draft are drawn from foreign advanced bankruptcy system, with an endeavor to bring China's bankruptcy legislation in line with international standards. This Draft is still subject to further revisions by the National People's Congress of China and the enactment has not been penciled down on the agenda of the national legislature until now. As such, it is not clear to what extent this Draft will be further revised and when it may be adopted.

Against this backdrop, to meet the urgent demands to hear more and more bankruptcy cases in China, the Supreme People's Court recently promulgated a judicial interpretation entitled Provisions on Several Issues in the Hearing of Enterprises Bankruptcy Cases (hereafter referred to as "The New Rules"). The New Rules signify a landmark development in the history of PRC bankruptcy laws and regulations.

II. The New Draft 2002

Draft 2002 composes of 10 chapters, 162 articles. It includes general provisions, application and acceptance of the bankruptcy case, administration of assets,

filing of claims, creditors' meeting, reorganization, composition, bankruptcy liquidation, legal responsibility and supplementary provisions. Several features in this Draft are summarized as follows:

1. THE SCOPE OF DRAFT LAW (ARTICLE 3, 160)

The scope of application defined in article 3 covers enterprise legal entities, partnership enterprise and its partners, individual proprietorship enterprise and its investor and other profit-making organizations which are established in accordance with law. This is a big improvement compared with the 1986 Enterprises Bankruptcy Law (EBL) which only applies to the State-owned Enterprises (SOEs). There are three issues arising from this scope of application:

First, the bankruptcy of SOEs. It is widely recognized that the bankruptcy of SOEs is a very tough issue in China. None of the major issues has been so hotly and intensively debated as that of SOEs bankruptcy. To a large degree, this constitutes one of the main impediments for the draft bankruptcy law not to be enacted until now in China. Draft 2002 covers the SOEs, but according to article 3, the State Council is authorized to stipulate regulations concerning special issues of bankruptcy conducted by SOEs that are established before the Company Law of the PRC took effect. Although this is a relatively pragmatic solution to deal with the SOEs bankruptcy in current state, it is still expected that there are a lot to debate before the Draft 2002 is enacted. Some strongly advised the new bankruptcy law should not cover the SOEs. Possibly the next draft will exclude SOEs from its scope.

Second, the consumer bankruptcy. Whether the Draft 2002 shall be widened to include natural persons (or consumers) or not also brings about a lengthy debate in China. Someone argue that it is necessary for China to introduce the consumer bankruptcy as soon as possible since more and more non-business persons have or may have personal debt problems. Although supporters list many reasons for China to create the consumer bankruptcy, there are also a lot of negative opinions. Consumer bankruptcy involves many issues that are considerably different from those in enterprise bankruptcy. More time is needed for China to consider this issue before making decision. In the Draft 2002, the natural persons who engage in the commercial matters, particularly the investor of sole proprietorship and the partners of partnerships rather than commons consumers are included. It is possible to add consumer bankruptcy provisions or to devise a separate law in the future.

Third, the bankruptcy of financial institutions. Pursuant to article 160, the bankruptcy of commercial banks shall not apply to the provisions of this law. In many jurisdictions, the bankruptcy of commercial banks is subject to separate

law as commercial banks are saving-taking deposits institutions which are heavily regulated. Given the deposit insurance has not been created in China until now, it might be appropriate not to cover any provisions on commercial banks in bankruptcy law. At a later stage, consumer bankruptcy and banking bankruptcy may be added to the bankruptcy law, or separate legislation may be necessary. There was some discussion as to whether the banking exemption should be extended to other types of financial institutions, such as Insurance Companies, Securities Company, etc. It may be subject to continuing debates in this respect.

2. BANKRUPTCY TEST—CASH FLOW (ARTICLE 4)

The Draft 2002 adopts the threshold criteria of cash flow for bankruptcy instead of balance sheet. Where a debtor is unable to pay off the debts due, its debts shall be liquidated in accordance with the procedures prescribed in this law. A debtor who ceases to pay off debts shall be presumed unable to pay unless otherwise provided. Some argue that the law shall establish a threshold criteria that combines both cash flow and balance sheet. But due to the operational difficulties arising from the balance sheet, the advice has not been accepted. But there is something to be clarified. For example, there is no answer of what 'cessation of payment' means or what is required to indicate there has been a cessation of payment.

3. ADMINISTRATOR (ARTICLE 16, 27-32)

Although some believe that China shall opt for the US model of DIP (debtor-in-possession) system, the Draft 2002 provides the appointment of an administrator. The power to appoint the administrator is given to the court. Article 27 sets out the qualification for an Administrator from both positive and negative aspects. A lawyer or a certified public accountant or a relevant social intermediary institution can be appointed as administrator. With the entry of China into the WTO, it is possible for foreign bankruptcy practitioners to be appointed as administrator.

The Administrator shall have a good reputation, necessary professional knowledge, have obtained the practice qualification through examination, and be neutral and independent. The State Council shall separately stipulate the qualifications of, and examining methods for, the Administrator. Individuals who have been given criminal punishment or have had their professional licenses revoked within a five-year period can not be appointed as an administrator. In the long term, the development of an appropriate training and certification program of administrator is very crucial to the operation of the new bankruptcy law. The functions, responsibilities and liabilities, remuneration and the replacement of the administrator are clearly set out in the relevant articles.

4. FRAUDULENT TRANSACTION AND PREFERENCES (ARTICLE 33-38)

To achieve the equitable treatment for all creditors, the Draft 2002 provides for the application of what are commonly referred to as “avoidance power”, among which are mainly fraudulent transactions or preferences. The administrator may try to rescind these transactions entered into by the debtor within a certain time of period (six months or one year under different circumstances) prior to the commencement of the bankruptcy case. But like the former edition, the Draft 2002 has still no provisions on “insider trading” which often occurs especially in the listed company. It makes no differences between insider trading and non-insider trading as to the length of relation back period.

5. THE CREDITORS’ MEETING (ARTICLE 54-64)

Chapter IV of the Draft 2002 composed of two sections deals with the creditors’ meeting. All creditors who have declared their claims according to this law are members of the creditors’ meeting. In this part, the most significant provision is article 56, detailing the broad “functions and powers” of the creditors’ meeting, such as investigating into the claims, deciding to continue or terminate the debtor’s business, etc. This is an illustration of the principle of “creditor’s autonomy” although the creditors’ meeting may be less important in some jurisdictions.

In this Chapter, the Draft 2002 also provides for the Supervisor, who may be selected and appointed by the creditors’ meeting and recognized by the court in written. Article 63 sets out the duties and powers exercised by the Supervisor, such as supervising the management and handling of the debtor’s property, the execution of the composition agreement, etc.

Given the Draft 2002 introduces such many functionaries as the Administrator, the Supervisor, the Chairman of the creditors’ meeting, the Court in the bankruptcy proceeding, it is very critical to properly allocate the relevant powers and responsibilities among them. There is something to be improved, particularly there may exist power struggles between the Supervisors and the creditors, or between the Supervisors and the Administrator.

6. REORGANIZATION (ARTICLE 65-94)

In conformity with the popular trend of modern insolvency regime, the Draft 2002 also incorporates the reorganization scheme. Actually one of the major focuses in the draft law is reorganization, emphasizing on promoting and encouraging the use of corporate rescue. There is a specific Chapter (Chapter VI) to deal with the reorganization.

The main contents of Chapter VI involve the application for and examination of reorganization, business operation during the interim period of reorganization, reorganization plan, etc. Articles 65-67 set out the reorganization application process. According to article 66, either debtor or creditor may apply for reorganization. Article 67 states that reorganization is only available for enterprise legal entities. This provision has experienced a lengthy debate on whether China should permit non-enterprises legal entities to use the reorganization scheme or not. The purpose of present provision is said to avoid possible abuse of reorganization and unreasonably delaying the realization of the creditor's right.

The Draft 2002 also provides for a definition of "protective period of reorganization" in article 68. The period may extend for up to six months and may be extended for an additional six months. In order to increase the possibility of reorganization, article 71 provides for the automatic stay against secured creditors and for the rights of secured creditors regarding their collateral.

7. COMPOSITION (ARTICLE 95-111)

There is constant advice to delete the composition from the Draft 2002, as it seems this proceeding has been seldom used in practice. But considering that composition is advocated by Chinese civil law and it shall play a role in resolving insolvency, it is appropriate to keep it in the Draft 2002. Article 95 limits the right of applying for composition only to the debtor.

In addition, it is possible to convert procedures between liquidation and composition. On the one hand, where the draft composition agreement is not passed at the creditors' meeting, the court shall declare the debtor bankrupt. On the other hand, after the court accepts the bankruptcy case, if the debtor reaches an agreement concerning the disposal of the claims and debts with the creditors who unanimously agree, they may request the court to make a decision, recognizing the agreement and at the same time terminating the bankruptcy case.

8. BANKRUPTCY LIQUIDATION (ARTICLE 112-148)

It is expected that liquidation proceeding will be most often used for resolving insolvency, compared with the two other proceedings: reorganization and composition. Chapter VIII deals with the declaration of bankruptcy, recovery of property and right to separate satisfaction, bankruptcy claims and right of setting off, appraisal, disposition and distribution of bankruptcy property and termination of bankruptcy proceedings.

There are some important articles which shall be paid more attention. According to article 114, termination of bankruptcy by the court before the declaration of bankruptcy is allowed where a third party guarantees, or pays off, the debts of the debtor, or the debtor has paid off all the debts that are due. Article 117 allows for the owners or other right-holders of property that does not belong to the debtor to get it back from the Administrator. Article 118 gives a right of stoppage in transit and recovery to a non-bankrupt seller who ships goods to a bankrupt that have not been fully paid for, but then gives the Administrator the right to pay the full price and receive the goods.

In addition, pursuant to article 134, bankruptcy property shall be sold by auction unless creditors provide otherwise. Article 135 stipulates the repayment order after deduction of the Expenses of Bankruptcy and Debts of Common Benefit from the bankrupt property as follows: workers' entitlements; taxes; ordinary bankruptcy claims. In the event that the bankrupt property is insufficient to meet the claims within a priority class, the distribution will be made on a pro-rata within that class.

9. LEGAL LIABILITIES (ARTICLE 149-159)

The provisions on "Legal Liabilities" in Chapter IX of the Draft 2002 are very meaningful, providing a mix of fines and liability for losses. That is, for some violations, only a fine is imposed. For others, liability for losses caused is imposed. In addition, the Draft 2002 raises the amounts of the fines imposed on various wrongdoings to a large degree, which is a response for strengthening the discipline associated with bankruptcy matters.

The Draft 2002 provides for three kinds of legal liabilities: administrative, civil and criminal in addition to disqualification. In particular, the Draft 2002 adds several articles on civil compensation that are not included in the previous drafts. A change was made in Article 157 from the 2001 Draft, with the article now imposing a fine rather than liability for losses caused, and eliminating any requirement of proof that losses were caused by the violation. Article 159 specially imposes liability on the Administrator, reorganization executor, or Supervisor for losses caused by negligence of duty or other unlawful activities, and if enormous losses occur, the responsible party may be fined, subjected to detention, or held criminally.

II. New Judicial Rules

The New Rules with 106 articles were promulgated on 30 July 2002 and came into effect on 1 September 2002. The following is a short summary of some

important provisions in the New Rules:

1. JURISDICTION (ARTICLE 1)

The bankruptcy case shall be under the jurisdiction of the court in the place of the debtor's domicile. The debtor's domicile means the place where the debtor establishes its main business organs. Where the debtor has no business organ, the bankruptcy case shall be under the jurisdiction of the court in the place of the debtor's Registered Office.

2. ELIGIBLE DEBTOR (ARTICLE 4)

The debtor applying for bankruptcy shall be a legal person. Non-legal-person enterprises, partnership may not apply for bankruptcy according to the New Rules. But foreign investment enterprise (FIE) is eligible to apply for bankruptcy provided that FIE is a legal person. This provision improves the hearing of FIE bankruptcy case as the previous provisions provided in Civil Procedure Law (CPL) of the PRC applicable to the bankruptcy of FIE are too simple to function in practice.

3. PREVENTION FROM ABUSING OF BANKRUPTCY PROCEEDINGS (ARTICLE 12, 14)

Avoiding the abuse of bankruptcy proceedings by the debtor or certain creditors who have illegal purpose is one of the main focuses of attention in the New Rules. To achieve this goal, the New Rules stipulates that the court shall not accept the bankruptcy application rendered by a debtor who conceals or transfers its assets and has original intention of escaping debts. Likewise, the same thing happens to a bankruptcy application rendered by a creditor who tries to impair fair competition through the bankruptcy application. Even after the court accepts the bankruptcy case, it still has the power to dismiss the bankruptcy case if the above situations are discovered.

4. ENTERPRISE SUPERVISION GROUP (ARTICLE 18)

After the court accepts the bankruptcy application, unless the court declares the debtor bankrupt and appoints the liquidation committee immediately, the court may appoint an Enterprise Supervision Group (ESG) if the original management of the debtor cannot perform its management duties. Members of the ESG are appointed from its superior department-in-charge or shareholders, the debtor's original management, its major creditors and intermediaries such as accountants and lawyers. The ESG, under the supervision of the court, is responsible for, inter alia, the protection of the assets of the debtor, verification of its debts and the performance of other work approved by the court.

The ESG performs among other things the functions of a provisional liquidation in common law jurisdictions and helps to preserve the assets of the enterprise for the benefits of its creditors at least before the appointment of the liquidation committee. This is a big improvement in China bankruptcy practice as it is common to find that assets of the debtor are illegally disposed of by the debtor's shareholders, employees or creditors. However, it is not clear whether the ESG will remain after the liquidation committee is appointed or whether the ESG should be dismissed and then its members should be reappointed as members of the liquidation committee.

5. COMPOSITION (ARTICLE 25-30)

The New Rules provides for composition and restructuring proceeding although there are very limited articles. The composition proceeding applies to all debtors. After the court accepts the bankruptcy case, the debtor may apply to the court for composition prior to the closure of bankruptcy proceeding. In addition, during the process of hearing the bankruptcy case, the court may also provide a composition proposal for the debtor and creditors to consider.

The restructuring proceedings are very simply stated in the New Rules. Only three articles deal with this important issue. The restructuring proceeding only applies to the SOEs. Moreover, the applicant can only be the superior department-in-charge of the SOEs. Where the SOE has no superior department-in-charge, shareholder's meeting may apply for restructuring. From these articles, it can be seen that the restructuring proceeding in the New Rules is devised under the China's national conditions and inconsistent with the international standard in this regard. Presumably, the very short provisions on the composition and restructuring may attribute to the main purpose of the New Rules—it mainly concerns the issues in the hearing bankruptcy cases.

6. LIQUIDATION COMMITTEE AND INSOLVENCY PRACTITIONERS (ARTICLE 48, 49 AND 75)

Members of the liquidation committee may be appointed from the superior department-in-charge, different government organs and intermediaries such as accountants and lawyers. With the court's approval, the liquidation committee may appoint intermediaries such as law firms and accounting firms to carry out debt collection and other liquidation work.

It is an encouraging sign that the important role of professional insolvency practitioners such as law firms and accounting firms has received judicial recognition in China. With the participation of such practitioners, the quality and speed of the bankruptcy procedure would definitely get better.

7. BANKRUPTCY ASSETS (ARTICLE 64, 73)

Bankruptcy assets shall include all assets owned or managed by the debtor at the time when it is declared bankrupt. Here an issue on whether the Chinese bankruptcy proceeding may affect the assets of debtor located outside of China arises from this provision. Although the New Rules gives no explanation to the meaning of “all assets”, it is still safe to draw a conclusion that the New Rules try to cover the assets located outside the China because article 73 states that the assets located outside the China shall be recovered by the liquidation committee. Certainly, how this provision could operate in practice is still not very clear due to lack of relevant supporting details.

8. RESERVATION OF TITLE (ARTICLE 71)

Whether to recognize the reservation of title or not in bankruptcy proceeding is a controversial issue internationally. According to article 71, bankruptcy assets do not include the assets of which the debtor has not acquired the title in a title reservation sale. In some jurisdictions the reservation of title is regarded as a non-possessory security interest. Its effect may not be recognized when the buyer becomes bankrupt. The New Rules adopts a contrary solution in this respect.

9. DEBT ALLOCATION (ARTICLE 94)

Debts owing to the debtor that have been classified as bankruptcy assets and verified by the court may be allocated to a creditor. The liquidation committee shall provide Debt Allocation Letters to such creditors who may then request the relevant debtors of the debtor of the debt to pay the debts directly to them. And if such debtors refuse to make payment, the creditor may apply to the court for mandatory execution measures against such debtors. Whilst this procedure seems to be rather creative and could reduce the burden of the liquidation committee and expedite the bankruptcy process, it is far from clear how it will function in practice.

10. SUPERVISION BY HIGHER COURTS (ARTICLE 104)

If the Supreme People’s Court or a higher court discovers any mistakes in any lower court bankruptcy decisions, it shall notify such lower courts to rectify the mistakes or order them to make new decisions.

With the introduction of the New Rules, the legal framework of Chinese bankruptcy procedure is now more detailed and self-contained, particularly when a new bankruptcy law does not appear due to various reasons. However,

there are still many provisions in the New Rules which require further judicial clarification in order to explain how they are intended to be applied in practice.