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

by

Wang Weiguo

and

Charles Booth

Report for the Project on Debt Restructuring of Enterprise from
The State Economy and Trade Commission of China
EXECUTIVE SUMMARY

**Graveness of the SOE Debt Problem.** Since 1990s, debt problem has been conspicuous and restricted the reform and the development of Chinese State-Owned Enterprises (SOEs). In 1994 about 63.9% of SOEs were in the condition of highly indebted operation and 22.5% of the SOEs were over-indebted with tremendous risk of insolvency. Related to this, the amount of bad loans reached 22.65% of the outstanding loans in the period in the commercial banks’ credit assets in 1995 and the actual situation was much worse than those figures.

The large proportion of banks’ bad assets was one of the major factors that caused the Asian financial storm in 1997-1998. The proportion of bad assets of the banks in China was in a higher position among the Asian countries. Since there are still various many unstable factors in the economy of the world at present, people should not underestimate the potentiality of global financial turbulence, that is likely to break out in the coming years. Therefore, to ensure the development of a stable and healthy economy of China in the future, it is of great significance to take efforts to solve the problem of the distressed SOEs and improve the quality of banks’ assets.

**Acts in Dealing with SOE Distress.** Realizing the great negative impacts of SOEs’ high indebtedness, the government is determined to resolve the problems of the huge bad debts, hoping to resolve three major problems, i.e., debts, personnel redundancy and social burden, in one package through debt restructuring of the national economy, so as to make substantive progress in the reform of the SOEs and the financial system.

*Clearing up “Triangle Debts (Chain Debts)”.* From 1990 on, the State Council had utilized various administrative methods together with a great deal of the debts’ clearing-up funds injected by the finance and banks with a hope to undo the debt chain one by one. However, as the complexity of the debt roots was underestimated, the above measures could not prevent the new debt chain from forming, and the administrative debt clearing-up turned into administrative financing to some extent.

*M&A and Bankruptcy under the Capital Structure Optimization Program (CSOP).* The debt restructuring in a large scale by the central government began with the CSOP carried out in some large pilot cities in
1994. It issued a series of administrative rules and regulations, which stressed that bankruptcy should be normative, merger should be encouraged, and provided various favorable policies. The national treasury therefore spent a huge amount of funds. Meanwhile, the State Council stipulated that normative bankruptcy of the state-owned industrial enterprises in the these pilot cities should be carried out under the principle that “the employees of the SOEs should be settled first when going bankrupt”.

Enterprises’ Search for Approaches of Debt Restructuring. Since 1994, encouraged by the central government, the local people explored boldly and developed some additional approaches such as: debt trusteeship; converting debts owing to employees into employee-holding internal shares; freezing the debts and government promised to use its income from assets to pay the debts; multi-parties assuming the debts in agreed manners under the coordination of the government; transferring the claims of banks by introducing third parties. However, in most of the approaches the future efficiency after restructuring were not taken into consideration, and the banks lacked the participating enthusiasm and often bore the net losses of the restructuring passively.

Intensive Handlement of the Bad Assets of State-Owned Banks. Affected by the Asian Financial Storm, the central government in 1998 began to shift the focus from debt restructuring to bank restructuring, in order to resolve the banks’ bad assets that accounted for 20-25% of the banks’ total assets. In 1999 the Ministry of Finance invested RMB 40 billion to set up four Financial Assets Management Companies (AMC) to take over the RMB 1200 billion of bad assets hived off from the corresponding state-owned commercial banks, hoping that the AMC could promote the reform and relief of the SOEs while activating the bad assets. However, in the debt-equity swap practice that bears the character of administrative plan, majority of the agreements stipulates that the enterprises shall buy back all the stock equity within 5-7 years and the local governments shall promise to take over the functions of social welfare from the enterprises. But in fact these are very difficult to be carried out. The cope of application of debt-equity swap practice is extremely limited. Among the more than 100 thousands SOEs all over the country, the number of the enterprises which could carry out the debt-equity swap was less than 0.5%.

“Changchun Approach” Emerged as the Time Required. The administrative measures and financial resources of the government are
inadequate. A large number of middle and small-scale local enterprises would not like to wait for death. Thus in many regions, enterprises and local governments began to seek for more flexible treatments to handle individual cases within the framework of the law. Enterprises and governments began to attach importance to the interests of the financial creditors and divert their attention on the capital market and title market. Some local governments now are no longer confined to settling the debts once for all any more and they are seeking actively for the optimization of assets, expansion of capital and long-term benefits together with the creditors. Sometimes the participants of the restructuring include non-local investors. As a result, some new approaches of debt restructuring come into being. An epitome of the developmental tendency can be found from the following “Changchun Approach”.

Since 1996, a new approach, so-called “Purchase-Sale Restructuring” (PSR), came into being. Under the mediation of Changchun Government, some SOEs negotiated with banks for rescuing the profitable assets and restructuring debts of the SOEs. Then a number of SOEs carried out this approach in succession and gained positive results. Up to July 2001, there were more than 40 local SOEs adopted the approach to restructure themselves and proved successful. In 2000, the officials from the State Economy and Trade Commission went to Changchun several times for survey and study. Therefore, this approach, locally-called “Purchase-Sale Restructuring”(PSR) and nationally-called “Changchun Approach”, began attracting people's attention form other regions in China as well as in the world.

**Basic Practice of “Purchase-Sale Restructuring”**. Based on the researches of a number of typical cases, we can sum up the basic points of PSR in Changchun as follows:

- The old enterprise who will adopt PSR shall be a SOE which is in insolvency but has profitable assets by which profits can be produced.
- Before PSR, the government should set up a new company, usually a wholly stated-owned company. The investment is often in the form of cash, sometimes plus the right of using land. After assets transaction, the company shall gradually covert into a multiple-shareholder company.
- The new company purchases profitable assets from the old
A relatively typical transaction arrangement is that the new company, the old enterprise and the primary creditors, (usually a bank who has two thirds of claims of the total debts of the old enterprise), enter into an agreement in a package concerning the old enterprise’s profitable assets valuation and transfer, and the sale of the assets and debt payment on the basis of full negotiation. The framework of the agreement can be illustrated in the following graph:

The transaction shown by the above graph mainly includes four stages: (1) the bank provides a loan to the new company to buy the profitable assets from the old enterprise, and the loan is almost equivalent to the assessed price of the profitable assets; (2) the old enterprise transferred its profitable assets to the new company at the contractual price; (3) the new company gives consideration to the old enterprise by the loan provided by the bank; (4) the old enterprise uses the money obtained to pay debts to the bank.

In the practice of the above assets transaction, the following measures are usually taken:

- Assessing the old enterprise in every aspect, mainly in profitable assets and product market. The targeted enterprise shall present a plan of restructuring. And the plan shall be discussed and proved by the relevant government departments.

- Abiding by law strictly in assets transaction. Firstly, the valuation of profitable assets shall be done by an authorized body. And the valuation result shall get consent of the Administration of State-owned Assets and the creditor (usually the primary creditor). Secondly, the plan shall get consent of the workers’ congress of the old enterprise. Thirdly, the
transaction shall be done in the Center of Title Transaction. After the agreement becomes effective, both parties should deliver assets and money to each other according to the list of assets valuation.

Resolving the problems of workers’ thoughts by the Communist Party of China and the Trade Union to obtain workers’ support and participation.

- The majority of workers from the old enterprise shall work for the new company, and shall sign a labor contract with the new company.
- The new company gets floating assets in various ways and uses the assigned profitable assets to produce marketable products. Thereafter, it shall reform its property right system and covert itself into a multi-shareholder enterprise such as share-issuing enterprise, shareholding cooperative enterprise, enterprise group, sino-foreign joint venture and cooperative enterprise.
- Proper disposition of the old enterprise’s residual assets. To those that are not effective for operation, bankruptcy shall be conducted. Those that are still effective for operation may remain. The new company may support the old enterprise in business or restructure it later at proper time concerning the residual assets.

**Effects of “Purchase-Sale Restructuring”**. We can see that Changchun’s PSR has achieved “multi-wins” for the debtor, local government and primary creditor. In general, this kind of restructuring has the following effects:

1. The profitable assets are hived off from the debts of the old enterprise and continue to operate and earn profits. And the new company who enjoys better goodwill and financial ability can operate the profitable assets well and expend its operation by issuing shares, obtaining foreign investment, and merger, etc.

2. The bank, as the primary creditor, has new credit to the new company by issuing loans. And the credit is believed a good one. At the same time, the bank has eliminated a part of bad debts with the sum equal to the payment by the old enterprise Thus the bank was repaid much more than that acquired through the old enterprise’s bankruptcy with its profitable assets (often 0-10% of total claims).

3. The employees of the old enterprise retain their employment and their wages in the new company are usually higher than before.

4. With much less money, the government fulfills renewal of state-owned
assets, maintenance of employment, and social stability, and can get taxes from the new company.

** Features of “Purchase-Sale Restructuring”**. Firstly, the Changchun Approach does not pay attention to the enterprises’ existing debts, but to their existing assets. Unlike the commonly-used repayment approach in debt restructuring, which keeps the profitable assets remain in the old enterprises and tries to decrease the debts imposed on the assets, it sets aside the large amount of debts and turns to rescue the productivity (profitable assets and labor forces) from the heavy debts by way of purchasing.

Secondly, compared with the other debt restructuring approaches based on the assets, the Purchase-Sale Approach of Changchun is characterized by hiving down the profitable assets from the debts of the enterprise and meanwhile hiving off the profitable assets from the non-profitable assets, so that the debt burden of the assets is lessened and the operating cost of the assets is reduced. Therefore the hived-down profitable assets have powerful capacity to expand capitals.

** Legal Analysis of “Purchase-Sale Restructuring”**. At first place, regarding the legality of assets transfer, there is no harm to the interests of creditors, because the old enterprise disclosed the information to the bank when selling the assets and negotiated with the bank repeatedly until reaching an agreement, and further the old enterprise got corresponding consideration when transferring the assets to the new company at the price that was legally evaluated and agreed by the creditor. This is different from the practice in some places to escape the debts by business separation of an enterprise.

Secondly, in considering the protection to primary creditors, liquidation test shall be adopted, that is, the repayment that the creditor can gain according to the restructuring project should be measured by that he may get in liquidation. In view of current enterprise bankruptcy practice, the legal protection to the creditors restrained by the urgent requirements to settle the workers. The repayment they receive from bankruptcy proceeding is very limited. Comparatively, the rate of repayment of the primary creditors in Purchase-Sale Approach of Changchun is much higher.

Thirdly, fairness to the middle and small creditors. Point one, if the transferred assets have already been mortgaged to the primary creditors, the middle and small creditors have no opportunity to recover them. Mortgagee is entitled to allow his debtor to transfer the collateral to a third party and get
repayment from the price gained thereby. Point two, if there is no mortgage on the main assets, and the insolvent enterprise has not entered into bankruptcy proceeding, the rule of the game then is individual repayment. However it is difficult to sell the production line of the distressed enterprise in piecemeal, and neither the middle and small creditors nor the court can easily find a purchaser who is willing to purchase the assets in whole, so that the middle and small creditors cannot get paid with these assets earlier than the primary creditors. In this case, if the primary creditors are prohibited from rescuing these assets as the going concern, while the middle and small creditors can not give any help, then the fate of the enterprise is close-down and bankruptcy. So, from the view of substantial justice, in restructuring it is more reasonable to carry out the rule of “participants getting benefit”, i.e. “those who contribute in rescuing the enterprise get benefit first”, than the situation in which “everyone waits for a free lift”. Point three, bankruptcy liquidation can hardly provide repayment to trade creditors, but leading to the decrease of their business clients. By contrast, restructuring may hold their market relations that are more valuable than the slight dividends from bankruptcy proceedings.

Fourthly, considering the interests of workers, it is the reality that the existing policy and legislation in present China provide a very strong position to SOE workers. The most concern of the workers is their employment. The transfer of the profitable assets brought about new job, the workers became the first beneficiaries in the assets transaction. Moreover, keeping employment is closely related with social stability, so that the local government is a beneficiary too.

Opinions of International Experts. Insolvency experts of 30 persons from 14 jurisdictions contribute their comments on Changchun approach. They indicate that, in essence, the Changchun model involves what is called in the West a “hive down” in which the profitable and higher quality assets are transferred to a new entity. In the Chinese version, the primary bank lender makes a loan to the new company that is equivalent to the value of these assets. The new entity uses these funds to purchase the assets from the old SOE, and the old SOE, in turn, uses the funds to repay the primary bank lender. Many of the experts have noted that the Changchun model has achieved some success, e.g. that profitable assets are freed from the burden of the old debts and thereby become better utilized; majority of the workers are able to retain their employment by switching to the new company.
However, many experts demonstrate their concerns about the Changchun Approach in regard to its underlying fairness. Further, they introduce the practice and experience of debt restructuring in their jurisdictions and provide suggestions on improving the restructuring models of China.

Theoretical Summary on Practices of Debt Restructuring. 1. We should keep on developing and utilizing market methods and market resources rather than simply rely on the administrative measures and governmental resources to rescue the SOEs. 2. Market transaction of assets and that of claims is of significance in using market means and resources to restructure the debts of SOEs. 3. Governmental functions and state-owned economic resources are also very important. As to the functions of government, the function of owner and that of coordinator are the most basic. 4. As to the function of State resources, attention shall be paid on existing resources and increasing resources in the process of debt restructuring. One of the most important kinds of existing resources is aggregated working, and another is the right of using land. 5. Valuations of assets and of business prospects before restructuring of the enterprises are critical for its success. Among others, the comparison between going-concern value and liquidation value should be paid attention to, and the ability of production, occupied shares in market, competition, profits, technology exploitation, investment attraction should be evaluated synthetically. 6. Restructuring plan is the result of the negotiation among multi-parties. The disclosure of information during the restructuring is one of the most important conditions needed to get the assistance of the creditors. Additionally, the function of intermediaries shall not be ignored. 7. It is especially important for restructuring and recovery of SOEs to respect well enough the workers’ democratic rights and labor rights. 8. Concession of the creditors and input of increased assets are two conditions indispensable to successful restructuring and rescuing of enterprises. Creditors should make certain about their boundaries of concession contrasted with the rate of repayment in the case of bankruptcy liquidation. 9. It is just the beginning of recovery of the enterprises to improve their financial positions through debt restructuring. To gain the survival and development in a long term, the enterprises should carry out their re-capitalization and technology improvement. 10. Because of the current situation of the old SOEs’ assets, it is an inevitable and unavoidable fact that creditors’ rights are devalued. Therefore, one of the tasks in restructuring is to allocate the losses of the
creditor's claims impartially. 11. The principle that “participants getting benefit” in The principle that “participants are benefited” from the debt restructuring is good to encourage the transfer of constructive assets and active concession of creditor's claims, which may save the cost of the negotiation. 12. Coordination of multi-goals should be achieved in debt restructuring. In various practice of debts restructuring hitherto, there are three goals to be attained: (1) to relieve distressed enterprises or otherwise to rescue their profitable assets; (2) to keep employment and settle the workers; (3) to protect the claims of financial creditors, especially those of State-owned banks. All the goals are the social issues that lead great pressure to the government at present, and the practice has proved that the three goals can be attained in one go. Moreover, the achievement of fair repayment to all creditors should be placed in an important position.

Improvement on the Model of “Purchase-Sale Restructuring”. Various improvements on the model of “purchase-sale restructuring” may be made in practice. By way of illustration, the Report brings forward six improved models, and further some addible factors. Besides, the instrument of trust is also applicable in debt restructuring.

Systematization of Debt Restructuring Process. For the sake of this systematization three basic objectives shall be established, i.e. legality, efficiency, and justice, and four elements shall be taken into account, i.e. motivation of banks’ participation, cost of negotiation in divergence, separate action by individual creditors, and clarification of relevant policies and regulations. Recently, some international organizations, e.g. the World Bank, INSOL, have proposed the principles and guidelines on out-of-court debt restructuring.

There are two applicable frames for the process of enterprise debt restructuring, the one is civil law frame and the other is bankrupt law frame.

Detailed Opinions on the Reconciliation and Restructuring of Bankruptcy Enterprise. 3. Suggesting the Supreme Court to issue relevant judicial explanations, e.g. Opinions on the Application of the Reconciliation and Restructuring of Enterprise Bankruptcy Law of the Peoples' Republic of China in the Debt Restructuring of Distressed Enterprise. 4. Carrying out corresponding measures to guarantee the implementation of the above administrative regulations and judicial explanations, e.g. pushing forward training programs, compiling operation guidance and case collection.

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Introduction

For a long time, debt-related distress of enterprises in China has been a major factor restricting the reform and development of Chinese state-owned enterprises (SOEs). In 1990s, the State Economy and Trade Commission (SETC) and other relevant departments of the Central Government took some major measures such as liquidating inter-enterprise debts ("triangle debts"), M&A, debt-equity swap, which have obtained some positive effects. As shown by experiences, it is a difficult and complicated task to relieve the enterprises from their debt-related distress. In the process of establishing and perfecting a socialist market economy in China, it is of significance for current SOE reform and economic development to search for more flexible and effective approaches in restructuring distressed enterprises by combining policy tools with market means and linking governmental resources with market resources. At present, some main features of SOEs’ distress are remarkable in China. First of all, the amount of debts in the distressed enterprises is huge and overdue for a long time. Secondly, their financial difficulties are connected with poor management, obsolete technology, bad market operation, redundant personnel and various social burdens, and so forth. Thirdly, the resources that can be used directly by the government to relieve enterprises from distress are limited by the present conditions of the state finance and bank assets. Finally, since the market for capital and property transactions is just starting to run, there lack a set of mechanism and relevant systems to absorb capital directly from society. Therefore, to solve the problems of distressed enterprises in China, what need to be handled urgently include, among others, how to learn the successful experience from abroad so far as the situations in China are concerned, and how to come up with new ideas on approaches and systems suitable for SOE reform.

With the enterprise reform deepening, China is confronted with the challenge of how to come up with new ideas on systems, measures, and channels to solve the difficulties and new problems, in which two points need special attentions:

1. How to search for more market alternatives to solve the existing problems.
2. How to explore creative and new ways of thinking, methods,
approaches and measures to alleviate enterprises’ distress, under the prerequisite of conforming with the current laws and protecting legal rights and interests of all parties, especially those of bank creditors.

With the economic reform deepening and the socialist market economy developing in China, we are glad to see that enterprises, financial setups and local governments have achieved remarkable success and produced much valuable experience in taking efforts to search for creative and new ideas and methods in dealing with the distress of enterprises by debt-restructuring. Among them, for example, there is a so-called “purchase-sale approach” in Changchun City, in which about 40 SOEs were restructured. It is significant to sum up these cases and search for more alternative approaches contributory to rescuing distressed SOEs, an important long time issue existing in China, and to promoting the future economic development in China as well. Meanwhile, we also realize that as a global economic problem the issue of business distress or insolvency has been a hard nut to crack to the governments and the international organizations worldwide, which have paid serious attention thereto. Therefore we can use for reference the experience in dealing with enterprises’ distress from foreign countries as well as the research achievements made by the international organizations.

The project “Study on Debt Restructuring of Enterprises in China” is led by Mr. Shao Ning and Mr. Zhou Fangsheng from the State Economy and Trade Commission (SETC). It consists of three topics. This report is one of them,* made by Professor Wang Weiguo from China University of Politics and Law and Professor Charles Booth from Hong Kong University. Some scholars and postgraduates at the two Universities participated in the task and a number of international experts submitted their comments and relevant information. Professor Wang is the writer of Part I, II and IV, and Professor Charles Booth Part III, of the Report.

The funds for this research come from the ASEM Grant sponsored by EC under the administration of the World Bank. We hereby express our sincere appreciation for their kind supports.

* The others are: “Suggestions on Policy and Law Concerning Financing and Restructuring Distressed Enterprises” by Professor Wu Zhidan, and “How to Utilize Capital Market in Debt Restructuring: Zheng Baiwen Case Study” by Mr. Gao Guanjiang.
I. Development of SOE Debt-Restructuring in China

1. Overview on Debt Problem of SOEs

Situation of Assets and Liabilities of SOEs

Since 1990s, debt problem has been conspicuous and restricted the reform and the development of Chinese State-Owned Enterprises (SOEs). An investigation in capital and liabilities of SOEs (trade and financial enterprises included) made by the State Assets Administration in 1994 shows that the liabilities-to-assets ratio (total liabilities to total assets) of SOEs reached 75.1% at that time, in which about 63.9% of SOEs were in the condition of highly indebted operation (the liabilities-to-assets ratio was between 60-100%), and 22.5% of the SOEs were over-indebted with tremendous risk of insolvency.1

According to the statistics from another comparatively overall investigation covering 302,000 SOEs carried out in 1995, the average liabilities-to-assets ratio was 69.3%; if the actual losses in the guise of receivables had been deducted from the total assets, the real liabilities-to-assets ratio would be 76.1%, while the liabilities-to-assets ratio of these SOEs was just 38.7% in 1980. That is to say, the liabilities to assets ratio was doubled in the 15 years. There were 51,000 SOEs with the liabilities-to-assets ratio above 100%, meanwhile, 61,000 SOEs with liabilities-to-assets ratio 100% or more with booking losses beyond the owners’ equities and were de facto insolvent. The above distressed SOEs amounted to 112,000 in total, accounting for 37.1% of all the SOEs involved in the investigation.2

In the statistics from the above investigation, there are two facts noticeable. Firstly, the liabilities-to-assets ratio after considering the factor of land valuation was 61.3% for large-sized SOEs, 72.9% for the medium-sized, and 76.9% for the small-sized, indicating that the liabilities-to-assets ratio of the large-sized was lower than that of the medium & small-sized. Secondly, the liabilities-to-assets ratio after considering the revaluation of the fixed assets and land was 34.2% for central SOEs, and 65.8% for local SOEs, showing that the liabilities-to-assets ratio of the central enterprises is much lower than that of the local. Thus, from the very beginning the distress among the medium & small-sized and the local ones was more serious than that among the large-sized and the central ones. In addition, the latter were normally given priority in policy preferences, and resources possession, etc. Hence, naturally, the important and difficult point of work in treating the distress of SOEs should mainly be focused on the medium & small-sized and local SOEs.

Due to the high indebtedness, the SOEs’ ability of making profits descended year by year. According to the statistics of the relevant agency, the total losses of SOEs in 1995 amounted to RMB 41 billion with RMB 7 billion per month increase compared to the previous year, in which the losses incurred in above one-third of SOEs, and the losses in the local industrial SOEs came to RMB 28.5 billion, accounting for 70% of the total losses. According to the calculation by the Economic Institution of the State Planning Commission, the total losses of independent accounting SOEs in 1995 increased by 48% and the growth margin increased 19% compared to the previous year; the total profits dropped by 35% or so and the descending margin increased 25%; in total about 60% of the SOEs were losing money, and the number increased about 20% compared to the previous year. The Production Department of the State Commission for Economic Reform and some other agencies carried out an investigation in the SOE management in 69 cities, showing that in spite of the serious situations being confronted, those SOEs still wished for survival. In the investigation, among the five offered choices, namely, bankruptcy, merger, hive down, sale by auction, and

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3 Lu Liling and Shen Ying, ibid., Page 9-14
4 Lu Liling and Shen Ying, ibid., Page 55
others, only 31% of them chose bankruptcy or sale by auction, while 69% chose merger, hive down and others.\(^5\)

Two more factors need to be considered in respect to the SOEs’ debt problem, which would help to evaluate objectively the impact of SOEs’ debt distress on national economy. One is the comparison between the liabilities-to-assets ratio of SOEs with that of other types of enterprises; another is the comparison between the different liabilities-to-assets ratios in different scaled SOEs.

**Table 1-1  Comparison of the Ratio of Various Industrial Enterprises in 1995**

<table>
<thead>
<tr>
<th>Owner-type</th>
<th>Total Assets</th>
<th>Total Liabilities</th>
<th>Liabilities-to-Assets Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOEs</td>
<td>47472.06</td>
<td>31149.10</td>
<td>65.6(,<em>) 74.2(,</em>)</td>
</tr>
<tr>
<td>Collective-Owned Enterprises</td>
<td>14360.07</td>
<td>10175.63</td>
<td>70.9</td>
</tr>
<tr>
<td>Share-holding Enterprises</td>
<td>4382.39</td>
<td>2405.96</td>
<td>54.9</td>
</tr>
<tr>
<td>Foreign-invested Enterprises</td>
<td>5798.22</td>
<td>3162.79</td>
<td>54.5</td>
</tr>
<tr>
<td>Enterprises Invested by Hong Kong, Macao, and Taiwan</td>
<td>6258.11</td>
<td>3891.94</td>
<td>62.2</td>
</tr>
<tr>
<td>All the Enterprises</td>
<td>78270.85</td>
<td>50785.42</td>
<td>64.8</td>
</tr>
</tbody>
</table>

*The data in the brackets is the liabilities-to-assets ratio, which was obtained after the actual losses in the guise of receivables had been deducted from the total assets.*

According to Table 1-1, the SOEs’ assets accounted for about 60% of the total assets, and the SOEs’ liabilities accounted for about 80% of the total liabilities. Therefore, to a great extent, the situation of the overall economic functioning is subject to the condition of the SOEs’ assets and liabilities, which indicates that it is especially significant to solve the problem of the distress of SOEs for the economic development in China.

### Table 1-2  The Proportion of Quantity of SOEs and Credit in 1996

<table>
<thead>
<tr>
<th>Quantity of SOEs</th>
<th>Total (10 thousand)</th>
<th>In which: the large-sized (%)</th>
<th>the medium-sized (%)</th>
<th>the small-sized (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>The Proportion of SOEs’ Credit in Total Domestic Credit (%)</td>
<td>81.37</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Assets</td>
<td>The Proportion of SOEs’ Assets in Total Domestic Assets (%)</td>
<td>58.61</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

From The Statistic Yearbook of China (1996), the Financial Yearbook of China (1997)

According to Table 1-2, the proportion of SOEs’ credit in the total domestic credit was higher than that of SOEs’ assets in total domestic assets. In other words, the preservation of the 80% credit in the country was subject to the 60% of SOEs’ assets. Consequently, it is of vital importance for the quality and safety of banks’ credit assets in China to solve the problem of the distress of SOEs and improve the quality of SOEs’ assets.

### Table 1-3  Information on SOEs’ Debt Scale in 1995

<table>
<thead>
<tr>
<th>Type of SOEs</th>
<th>Liabilities (100 million RMB)</th>
<th>Proportion in Total Liabilities (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large-sized</td>
<td>18611.04</td>
<td>59.7</td>
</tr>
<tr>
<td>Medium-sized</td>
<td>6771.12</td>
<td>21.8</td>
</tr>
<tr>
<td>Small-sized</td>
<td>5766.94</td>
<td>18.5</td>
</tr>
<tr>
<td>Total</td>
<td>31149.10</td>
<td>100</td>
</tr>
</tbody>
</table>

From: the Statistic Yearbook of China (1996)

It can be seen from Table 1-3 that, in spite of the higher liabilities-to-assets ratio of medium & small-sized SOEs, their liabilities only accounted for 30% of the total liabilities of SOEs. It is also testified by international practice that the rate of the successful restructuring of large enterprises is higher than that of the medium & small enterprises.\(^6\) Therefore, it is understandable why in recent years our country managed to assist many

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\(^6\) According to the estimate of the specialists, in USA the general ratio of the successful corporate rescue according to Chapter 11 of the American Bankruptcy Law is generally around 20%, while that of large corporations is 80-90%; in Japan, for many years, almost all the enterprises whose recovery by restructuring successfully in application of Association Restructuring Law are large enterprises.
large SOEs and formed lots of large enterprise groups through restructuring and merger, which contributed much to the alleviation of the overall tension of SOE distress, and also it can be explained why the economy of China keeps on increasing even though the overall situation of SOE distress was very serious.

**Conditions of Banks’ Bad Assets**

The issue of debt distress of SOEs is closely related to the conditions of banks’ bad assets. Since the economic reform and opening to the outside world, the credit relationship between SOEs and banks, and the forming of banks’ bad assets have gone through the following three stages.

**The first stage: before 1983**

At that time when the economic reform just started, there was no concept of commercial bank. All the banks then performed as cashiers of the financial department of the government. The fixed assets and floating funds of SOEs all relied on fiscal allocation. Only were the excess of the allocation quotas and some occasional investment for fixed assets borrowed from banks. The amount of total loans for the nationwide industrial enterprises were RMB 48.7 billion in 1980, and increased to 52.7 billion in 1982, RMB 59.7 billion in 1983, and the banks had no bad assets incurred by loans to SOEs.

**The second stage: from 1984 to 1990**

During this period, with the market elements increasing, the credit relationship between SOEs and banks and the concept of commercial banks emerged. The so-called “shifting from allocation to loans” (“bo-gai-dai”), by which the investment in infrastructure construction came from bank loans rather than from the fiscal allocation, was one of the major measures in the investment system reform. Since the major capital of the enterprises relied on loans from the banks, the scale of the bank credit expanded rapidly, and bad loans were hence formed. In most years of this stage, the ratio of the bad assets to total assets of the banks was less than 10%, and until the end of 1980s the ratio just arrived at about 15% (the amount of the total bad assets was less than RMB 200 billion).
The third stage: from 1991 to 1998.

It is the period that during which the amount of bad assets of banks swelled dramatically. According to the calculation of some specialists, the amount of SOEs’ bad debts increased five times in the five years from 1991 to 1995, which was RMB 213.3 billion, 420.6 billion, 547.7 billion, 853.4 billion, and 1059.8 billion respectively. Accordingly, the amount of banks’ bad assets increased about four times in the five years. Of the new bad assets, the amount due to the foam of real estate and stock market in the overheated economy accounted for 32%, and the amount due to debt distress in SOEs accounted for 48%. Among the bad assets caused by the distress of SOEs, about one-third was caused by the loans made for the sake of social stability in light of the administrative orders, about one-third bad debts resulted from production loans made for the sake of relieving the enterprises’ distress, over one-sixth debts were written off because of some enterprises’ bankruptcy, and another one-sixth was bad debts resulted from false operation and sightless loans of the banks.7

According to the estimate of the specialists, in 1994 two-thirds of the total debts of SOEs owed to the banks.8 According to the statistics of utilizing state funds in the Financial Yearbook of China 1996, the loans to SOEs accounted for 58.73% of the total loans. Moreover, according to the Economic Yearbook of China 1996, the ratio of profit & tax to capital of the financially independent SOEs was 24.8% in 1980, 23.8% in 1985, 12.4% in 1990, 8.01% in 1995 respectively. In other words, about 60% of bank loans had been invested in some inefficient and low profits SOEs.

It is shown in an investigation that the amount of bad loans reached 22.65% of the outstanding loans in the period in the commercial banks’ credit assets in 1995. Of the amount of bad loans, over-due loans accounted for 13.99%, non-performing loans 6.67%, and bad debts 1.99% in all the loans of the same period. However, the actual situation was much worse than those figures.9 According to a typical survey, there were considerable loans that

7 Fan Gang, ibid., Page 102-103.
8 Fan Gang, ibid., Page 64.
9 Lu Liling and Shen Ying, ibid., Page 16-17.
were not included in bad loans, which kept operating by taking advantage of the “rolling approach”, a way that the banks made new loans to the enterprises to pay off the old loans. Furthermore, about 60% of the non-performing loans had turned into bad debts. Thus, on the basis of the calculation, the actual proportion of bad debts in the outstanding loans in the corresponding period would have reached to 5.99%.

In 1995, China promulgated the Commercial Bank Law, making legal requirements for the safety of bank assets. Aiming at the mess of bad assets in commercial banks that were increasing strikingly, the Central Bank strengthened the control and supervision over the commercial banks and demanded that the ratio of all the commercial banks’ bad assets be dropped by 2-3% each year. Under this pressure, the commercial banks came up with two “countermeasures”. One was called “shifting loans”, i.e., concealing the real bad assets artificially in the book entries by making new loans to pay off the old loans, which in fact accumulated the potential financial crisis. Another was called “reluctant to loan”, i.e., no loan would be made unless there was 100 per cent certainty of repayment, a practice which not only led to considerable interest losses (some of the losses were shifted to the Central Bank by increasing the bank deposit reserves), but also worsened the distress of SOEs, which would finally result in the loss of bank assets.

The large proportion of banks’ bad assets was one of the major factors that caused the Asian financial storm in 1997-1998, which had stroked the economies of Thailand, Korea, Malaysia and Indonesia heavily. The financial sectors of China escaped the crisis by sheer luck due to some reasons such as the relatively closed financial market. However, it had inevitably borne the depression for several years. It can be seen in Table 1-4 that the proportion of bad assets of the banks in China was in a higher position among the Asian countries. Since there are still various many unstable factors in the economy of the world at present, some specialists appealed that we should not underestimate the potentiality of global financial turbulence, even crisis, that is likely to break out in the coming years. Therefore, to ensure the development of a stable and healthy economy of China in the future, it is of great significance to take efforts to solve the problem of the distressed SOEs and improve the quality of banks’ assets.
Table 1-4 Proportion of Bad Assets of Banks in Some Countries/Regions in Asia

<table>
<thead>
<tr>
<th>Countries /Regions</th>
<th>The Present Proportion (%)</th>
<th>The Proportion at the Peak (%)</th>
<th>The Bad Assets at the Peak to GDP (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>2.0</td>
<td>&gt;8</td>
<td>9</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>2.1</td>
<td>&gt;8</td>
<td>13</td>
</tr>
<tr>
<td>India</td>
<td>17.0</td>
<td>15</td>
<td>4</td>
</tr>
<tr>
<td>Philippines</td>
<td>3.4</td>
<td>10-15</td>
<td>7</td>
</tr>
<tr>
<td>Malaysia</td>
<td>5.6</td>
<td>&gt;20</td>
<td>28</td>
</tr>
<tr>
<td>China</td>
<td>20.0</td>
<td>&gt;25</td>
<td>24</td>
</tr>
<tr>
<td>Indonesia</td>
<td>9.2</td>
<td>40</td>
<td>25</td>
</tr>
<tr>
<td>Korea</td>
<td>14.0</td>
<td>&gt;25</td>
<td>34</td>
</tr>
<tr>
<td>Thailand</td>
<td>18.0</td>
<td>&gt;25</td>
<td>40</td>
</tr>
</tbody>
</table>

From: IMF, Goldman Sachs.10

2. Acts in Dealing with SOE Distress

Realizing the great negative impact of SOEs’ high indebtedness on national economic development and institutional innovation in state-owned sector, the government is determined to resolve the problems of the huge bad debts. The government hopes to resolve three major problems in one package through debt restructuring of the national economy, i.e., debts, personnel redundancy and social burden, so as to make substantive progress in the reform of the SOEs and the financial system, achieve the strategic adjustment of state-owned sector, and establish and develop the socialist market economy.

Clearing up “Triangle Debts”—Chain Debts

In fact, since the third quarter of 1988, Chinese government started to make great effort to clear up the SOEs’ debts macroscopically. Led by the local governments and specialized banks the campaign of clearing up the “triangle debts” was launched in a great scale. After 1990, the “Triangle

10 Quoted from Lei Jiashu, Financial Safety of China---Issue on the Level of System and Outcomes.
Debts” Clearing-up Office, set up by the State Council especially, had utilized various administrative methods together with a great deal of the debts’ clearing-up funds injected by the finance and banks (the funds reached to RMB 33.05 billion in 1991) with a hope to undo the debt chain one by one. This kind of organized central administrative policy of debts clearing up was effective in a short term (for example, in 1991 the fund of 1 yuan could clear up the defaulted debts of 4.1 yuan). However, as the complexity of the debt roots was underestimated, the above measures could not prevent the new debt chain from forming, and the administrative debt clearing-up turned into administrative financing to some extent. As a result, the People’s Bank of China stopped the practice of “financing for debt clearing-up” in 1993. But the clearing-up of the “triangle debts” has aroused people’s attention to the issue of the enterprises’ debts, and it initiated the study on the issue in the level of policy and law in China. Some organizations that could meet the requirements of market were set up, such as the Debt Trading Credit Center in Liaoning Province, which is still playing a role in debt clearing-up now.

At present, it is still very serious for the SOEs owing debts due to each other. There are a great deal of accounts receivable and accounts payable booked in almost every SOE, which could not be received or would not be paid for a long time. It is estimated that the debts of the SOEs in the country defaulted with each other have reached to RMB 800 billion. \(^{11}\)

M&A and Bankruptcy under the Capital Structure Optimization Program (CSOP)

The debt restructuring in a large scale by the central government began with the CSOP carried out in 18 large pilot cities in 1994. Inspired by the successful practice of merger since 1989, the central government issued a series of administrative rules and regulations to implement CSOP, which stressed that bankruptcy should be normative, merger should be encouraged, and both would be favored in policy preferences. This kind of debt restructuring utilized several approaches synthetically such as bankruptcy, merger, and financial funding, write-off of bank debts, and returning from

“the fiscal allocation to bank loans” to “bank loans to investment”. In addition, according to the policies, enterprises that bore relatively heavy burden of debts and were not qualified to be merged could reduce their employees, and the loan interests of the enterprises owing to the banks could also be reduced. At the end of 1996, the funds with the principal and interests from “allocation to bank loans” amounting to RMB 24.2 billion were switched into state capital funds, which was used to handle the problems thoroughly in special industries such as coal industry, military industry, water and electricity industry. Furthermore, the sum of RMB 30 or 40 billion from central finance was taken out each year to make up for the losses of SOEs.

Since July 1, 1994, the practice of replenishing operating funds to state-owned industrial enterprises was carried out in the pilot cities, which required the enterprises to use a certain proportion of profits after taxes to supplement their working funds before drawing surplus accumulation funds, and meanwhile, the financial departments at the same level were required to allocate 15% of total income revenue turned in by the enterprises to supplement their working funds. In fact, even 100% of the income taxes were returned to the SOEs in many cities. However, the practice of financing directly with the financial increased capital alone was not satisfactory.

Circular Concerning Carrying Out State Owned Enterprise Bankruptcy in Some Cities (Guo Fa, 1994 No. 59), issued by the State Council in October, 1994, stipulated that normative bankruptcy of the state-owned industrial enterprises (SIEs) in the 18 pilot cities should be carried out under the principle that the employees of the SIEs should be settled first before going bankrupt. Moreover, many problems of the insolvent SIEs were stipulated specifically in the Circular, such as the disposal concerning the right of land using, properties of insolvent enterprises, the settlement of the workers of the insolvent enterprises, the credit losses of banks due to the insolvency, and complete take-over, restructuring of the insolvent SIEs, and organization and administration, etc. This indicated that the central government decided to utilize the land using right and the net assets increase (even stock) of the state owned banks to pay off those past debts in the way of enterprise bankruptcy, which included the hidden debts such as annuities, compensation for giving up the status as the workers of SOEs, and other rights based on the SOE worker status, for example, the right of obtaining employment again. The
specific approach was: (i) using the income of the sale of the right of land using and payment got by cashing the insolvent properties to settle the workers; (ii) writing off the losses of the banks after verification by the bad debt reserves quotas controlled and used by the People’s Bank of China (PBC) and STEC. In November 1994, the Supreme People’s Court issued *Urgent Notice Concerning Problems in Enterprise Bankruptcy Cases Heard in the People's Courts*, in order to carry out Guo Fa, 1994 No.59.¹² Thus, a set of procedures called “Planned Bankruptcy” was in fact created out of the bankruptcy proceedings of the current law.

The approach gradually spread in the country. The number of pilot cities increased to 56 in 1996, and 111 in 1997, and the amount of bad debt reserves quotas increased from RMB 7 billion in 1995 to 20 billion in 1996, and again from 30 billion in 1997 to 40 billion in 1998.

Meanwhile, the central government promulgated a series of normative decrees regarding “Planned Bankruptcy” in the CSOP. In July 1996, SETC and PBOC issued *Notice on Some Issues Arising in the Experimental Merger and Bankruptcy of SOEs* (Guo Jing Mao Qi, 1996 No. 492), which stipulated provisions concerning the mechanism of “Merger and Bankruptcy; Employee Reduction and Efficiency Increasing”, the rescue of insolvent SOEs on the verge of bankruptcy, bank representatives participating in making the bankruptcy plans, settlement of the workers, writing off the non-performing and bad debts, bankruptcy of domestic/foreign trade enterprises, and coordination between the departments of government, etc. Moreover, it arguably provided that property under mortgage could be used to settle the workers. *Supplementary Notice on Problems Pertaining to the Trial Implementation of the State-Owned Enterprise Merger and Bankruptcy and Re-Employment in Certain Cities* (Guo Fa, 1997 No. 10), issued by the State Council in March, 1997, stipulated specifically the following problems, such as organization and administration of experimental implementation, planning, examination and approval, preparation for bankruptcy, assets valuation, disposal of insolvent properties, settlement of workers, bad debts write-off, 

¹² Fa Fa, 1997 No. 2, *Notice Regarding Notable Issues Pertaining to Current Enterprise Bankruptcy Cases Heard in the People's Courts*, issued by the Supreme People’s Court on March 6, 1997, further stipulated how to carry out the related decrees issued by the State Council.
investigation into the responsibility for insolvency, lay-off and disposition, reduction and exemption of interests, and so on.\textsuperscript{13}

It needs to be noticed that, according to these documents, the merger of enterprises was emphasized as an important measure, which could be used in conjunction with bankruptcy or by itself. The mergers could enjoy the preference in policies such as suspending debt interests, exemption of debt interests, repayment before the income tax, and extending credit maturity. Furthermore, the enterprises in the CSOP could be favored with the preference of writing off the debts according to the sum approved. In reality, many local approaches were adopted in insolvent enterprises, such as “bankruptcy first, then merged”, “combining bankruptcy with mergers” (“purchasing whole”), “splitting first, then going bankrupt” etc., which in effect led to the low repayment rate to creditor banks when the enterprises went bankrupt. Lack of the bad debts write-off quotas allocated administratively, the bad debts of banks increased distinctly. Under the

claims of the commercial banks, Guo Fa, 1997 No. 10 discouraged the practice that the enterprises went bankrupt through “purchasing whole”, and reduced the number of insolvent enterprises that did not involve mergers or were not qualified to write off the bad debts. Meanwhile, the document expanded the range of the cities in the CSOP and increased the write-off quotas, which in fact encouraged the restructuring in the form of merger while taking efforts to restrain the practice from shirking responsibility for creditors through going bankrupt. Based on the debt-undertaking mergers, some mergers by market means such as cash-purchasing mergers, stock-absorbing mergers, and stock-holding mergers were created in practice, which promoted the debt restructuring. Meanwhile, encouraged by the Guo Fa, 1994 No. 59, the approach of hive down was widely used to save profitable assets of the enterprises.\textsuperscript{14} Of course, many cases were not real restructuring and violated legal procedures. Therefore, Article 90\textsuperscript{th} of Contract Law of the People’s Republic of China, effective in October 1999, stipulates explicitly and strictly the issue of assumption of debt obligations after the separation or mergers, which has actually banned in shirking the responsibility for creditors through merger or hive down.\textsuperscript{15}

At the beginning of 1998, the State Council proposed that three years be spent in reforming, restructuring, transforming, and strengthening the management of the SOEs to relieve most of the loss-makers among large & middle-sized SOEs out of the distress. In September 1999, the Decision of Several Significant Issues on the Reform and Development of State-owned Enterprises made at the 4\textsuperscript{th} plenary meeting of the 15\textsuperscript{th} Central Committee of the Chinese Communist Party required that the bad debt write-off reserve fund of the bank be increased to support merger and bankruptcy of the large

\textsuperscript{14} Article 8\textsuperscript{th} of Guo Fa, 1994 No. 59 stipulates, “If the bankruptcy has been consented by the creditor(s) whose credits amount to more than two-thirds of the total debts of the enterprise and approved by the government of the county municipal district, where the insolvent enterprises were located, profitable assets can be hived off from the enterprise going bankruptcy. The enterprises established after the hive down shall assume the debts of the old enterprise according to the agreed proportion.”

\textsuperscript{15} Article 90\textsuperscript{th} of Contract Law of the People’s Republic of China, effective in October, 1999, stipulates that “If one party to a contract is merged after the contract has been entered into, the legal person or other organization established after the merger shall exercise the contract rights and perform the contract obligations. If one party is hived off after the contract has been concluded, the legal persons or other organization thus established after the hive down shall exercise the contractual rights or assume the contractual obligations jointly and severally unless the creditor and the debtor have agreed on it.”
& middle-sized SOEs, and close the out-of- resources mines, and lay particular stress on the major industries. As a result, bankruptcy again received much attention. However, from 1999 to 2000, there was a big change in the CSOP, in which the write-off quota was no longer fixed and the general office of the four banks was able to negotiate with the SETC to decide the list of the enterprises that were going to enter into bankruptcy. The total sum of write-off quota in fact was RMB 18 billion in 1999, which focused on the bankruptcy cases of the money-losing large-sized SOEs.

Table 1-5: Statistics of the Bankruptcy Cases Tried by All the People’s Courts in China

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of the Accepted Cases</th>
<th>Number of Closed Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>SOEs</td>
<td>Non-SOEs</td>
</tr>
<tr>
<td>1989</td>
<td>98</td>
<td>—</td>
</tr>
<tr>
<td>1990</td>
<td>32</td>
<td>—</td>
</tr>
<tr>
<td>1991</td>
<td>117</td>
<td>—</td>
</tr>
<tr>
<td>1992</td>
<td>428</td>
<td>171</td>
</tr>
<tr>
<td>1993</td>
<td>478</td>
<td>307</td>
</tr>
<tr>
<td>1994</td>
<td>1625</td>
<td>635</td>
</tr>
<tr>
<td>1995</td>
<td>2583</td>
<td>1232</td>
</tr>
<tr>
<td>1996</td>
<td>5875</td>
<td>3651</td>
</tr>
<tr>
<td>1997</td>
<td>5396</td>
<td>3060</td>
</tr>
<tr>
<td>1998</td>
<td>5673</td>
<td>3056</td>
</tr>
<tr>
<td>1999</td>
<td>5622</td>
<td>2886</td>
</tr>
<tr>
<td>2000</td>
<td>7219</td>
<td>3296</td>
</tr>
<tr>
<td>Total</td>
<td>35146</td>
<td>18617</td>
</tr>
</tbody>
</table>

Data from: the Statistics of the Supreme People’s Court in March 2001.

It is indicated in Table 1-5 that from 1994 to 1996, the number of the bankruptcy cases of the SOEs tried in the courts all over the country increased like geometric series, however, from 1997 to 1999, the number decreased while the tendency to increase was stable. The rapid growth in the first three years was due to the sudden deterioration of the state-owned enterprises’ debts and losses at that time, while with the policy-covered pilot areas expanding, however, the number of the cases accepted by the courts did not increase in the last three years. It not only indicates that the controlled “planned bankruptcy” was functioning in some degree, and more importantly shows that the approach of bankruptcy to resolve the issue of the enterprises’
debts was limited: on the one hand, the financial ability of the government to write off bad debts and settle the workers was limited; on the other hand, the manpower and material resources that the courts could utilize to try the cases were not enough.

On the basis of the data gained by the SETC, there were 3,365 SOEs all over the country from 1996 to 2000 that went bankrupt according to the CSOP, while the number of the settled bankruptcy cases of SOEs all over the country reached 12,181 from 1997 to 2000. It means that more than 70% of the SOEs’ bankruptcy were not implemented according to the CSOP and the capacity of the Planned Bankruptcy in the controlled scale of the SOEs’ bankruptcy is limited.

In the process of enforcement of the Planned Bankruptcy, the banks have showed their strong discontent. In November 1996, it was pointed out at the joint meeting of the presidents of financial claim management banks in the country that according to the investigation of 145 bankruptcy cases of the state-owned enterprises of 35 provinces, the general liabilities-to-assets ratio was very high (about 165%) while the general rate of payment was very low (the average rate nominally was only 9.2%), in which the state-owned banks suffered damages heavily. The prominent problems reported in the meeting were that: (1) the enterprise bankruptcy had gone beyond the stipulated areas, and the bankruptcy took place everywhere; (2) the local protection was so serious that it had damaged the legal rights of creditors; (3) the methods of artificially going bankrupt and truly dodging creditors such as “hive down first, then going bankrupt” and “absolute division between the new enterprises and old ones” were practiced in the enterprise bankruptcy; (4) the drain on the state-owned assets was serious; and (5) the costs for the bankruptcy were too expensive. Then it was proposed at the meeting that we explore actively a specific method of restructuring the enterprises’ assets in which the creditors can participate beyond the bankruptcy proceedings, and encourage more mergers and less bankruptcy. And it was also pointed out at the meeting that it was not a rational method for the bank to pay off all the costs of the enterprises’ reform and we need to study and seek for a new way in which the financial department and the enterprises’ investors together with the banks shall take the responsibility to pay off the costs of the enterprises’
In March 2001, the World Bank issued a report named as the \textit{Research of the Bankruptcy of State-owned Enterprises of China --- the Necessity and Way to Reform the Bankruptcy System}. The report analyzed the existing problems in the system of the enterprise bankruptcy in effect in our country and put forward 29 recommendations for reform. One of the recommendations reads: “The legal framework for conventional workout practices should be strengthened to make it easier for banks to engage in rationalized debt treatment, such as maturity extensions and reductions of loan principal (“haircuts”), to help avoid the bankruptcy of potentially viable firms.”

\textbf{Enterprises’ Search for Approaches of Debt Restructuring}

To explore approaches of debt restructuring, Guo Fa, 1994 No. 59 stipulated that the government of the county or municipal district of the insolvent enterprises could restructure the enterprises with the measures of reorganizing the managers, changing the form of the operation of the assets of enterprises, and guiding the adjustment of the structure of enterprises. According to the relatively common approaches, the basic idea of debt restructuring of enterprises is to start with two channels: adjustment of debts in stock and injection of increased assets.

At first, for the adjustment of debts in stock, “emphasis should be given on clearing up system related debts through various forms of debt-equity swap adopted within the state-owned sector (mainly referring to the debts due to the finance, enterprises or employees) in order to activate stock assets of state-owned enterprises”.\footnote{The Accessories of Yin Fa, 1996 No.413, \textit{Notice on Issuing “the Summary of the National Joint Meeting of Presidents on Management of Financial Claims”}, issued by the People’s Bank of China.} There were several main approaches in the practice such as converting the financial debts into equity (switching from loans to investments, converting loans by municipal financial departments and local taxes in arrears that enterprises owed to localities into state equity...}
capital injected into enterprises), converting funds raised from employees into employee-holding internal stocks, converting the inter-enterprises debts into equity, suspending payment of certain bad debts and interests, separating non-performing assets from the enterprises and entrusting them to a trustee institute, trading the claims of banks at a discount or writing off the debts directly.

In the second place, while injecting new capitals we should focus on establishing a new mechanism, and we should renovate the system of enterprises and promote all the relevant reforms. There were several main approaches in practice such as debt trusteeship, listing through enterprise restructuring, raising State-owned Enterprise Promoting Fund, and promoting actively the transfer of state-owned property.

During the period, the local governments explored boldly and developed some additional approaches such as:

1. Debt trusteeship. In practice, there were several types of trusteeships, such as Hainan approach of the governmental trustee, Guangfayuan approach in which the non-bank financial institutions were the trustees, Xian approach, which accumulated the experience that intermediate investment institutions jointly contributed funds to form trusteeship institutions, and Jiangxi approach, a practice that the money-losing enterprises were entrusted to better-performing SOEs first, then acquired by the better-performing SOEs later etc.  

2. Converting debts owing to employees into employee-holding internal stocks. For example, not only the debts such as wages, welfare funds, bonus, funds for the welfare of employees, and funds for public welfare, but also funds raised from employees or funds for security of risks, and debts owed to the employees who paid debts for the enterprises could be converted into stocks.

3. Freezing the debts. The government promised to use the income of

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assets (including the income receivable of public finance) to pay off the frozen debts. It is known as the approach of Shaoguan in Guandong province in 1996, solidifying the debts and reconstructing the mechanism.  

(4) “Marketing negotiation”, i.e., under the coordination of the government, multi-parties assumed the debts according to the agreed sum and manner. The practice in Taian, Shandong province was a case in point. 

(5) Transferring the claims of banks via the third parties. It is known as “the Return and Sale of the Mortgaged Assets”(RSMA), which is the practice in Jinan Monosodium Glutamate Factory, in Shandong province in 1996. 

Under the macro guidance of the central government and the micro efforts of the related parties, the liabilities-to-assets ratio of the SOEs declined yearly, and reached to 64.41% in 1998. The listing of some SOEs, joint investment of the non-SOEs, cooperation with non-SOEs, collectivization of SOEs, sale of the medium & small-sized SOEs also contributed to the decline. However, the liabilities-to-assets ratio in the old industry districts still remains high, the situation of the loss of the SOEs is still serious, and especially the assets of banks keep on deteriorating. 

Obviously, most debt restructuring in this period were initiated or driven by the departments of the government in charge of the enterprises, who tried their best to utilize governmental resources and policy tools to adjust the relationships among financial department, banks, state management company, enterprises and the employees concerning their claims and debts in order to settle the bad debts once for all and decease the liabilities-to-assets ratio of the enterprises. However, the future income or efficiency of

21 Zhang Yunting, ibid., Page237-243; Chi Fulin, SOEs Reform and Debts, Foreign Languages Press, 1998, Page 210-212. In the case of foreign trade corporation of livestock product in Taian, Shandong, the bank, the enterprises and the government agreed to restructure the debts of the enterprises through the approach of “part of stock assets activated, part of stock assets discharged, part of stock assets written off”, which means that the activated assets by hive down were used to repay the debts of RMB 6 million, the debts of RMB 1.5 million was repaid through bankruptcy, and the rest debts of RMB 15 million were written off with approval.
22 Financial Institution of PBC, Debt Restructuring of SOEs and Assets Protection of Banks, Economics Science Press, 1998, Page247-253. The so called RSMA means that the bank transfers the profitable assets pledged by the enterprise when getting loans to a third party, who assumed the secured debts.
post-restructuring were not taken into consideration in most of the approaches, and the banks lacked the participating enthusiasm and often bore the net losses of the restructuring passively, not only in the normative restructuring, but also in the less normative restructuring. In this period, debt restructuring of the enterprises was prone to transfer the costs of rescuing the enterprises to the banks. It was quite common that the restructuring was short of transparency and mechanism of negotiation with bank creditors, which was in some degree worsened by the resistance from the banks and mechanism of banks’ over self-protection.

Generally speaking, the passive comments from the banks on the above approaches of the debts restructuring of SOEs were more than the positive ones. In 1998, the Financial Research Institute of the People’s Bank of China (PBC) cooperated with the subsidiary banks in 16 provinces, and published the report of Debt Restructuring of SOEs and Assets Protection of Banks. Based on the survey of more than 100 plants, five points of negative impact regarding the debt restructuring of SOEs were discussed in the report: (i) the passive position of banks in effect increased the degree of difficulty in protecting banks’ assets; (ii) the approaches of debt restructuring were taken advantage of to suspend and shirk or default the claims of banks; (iii) sometimes the liabilities-to-assets ratio after the restructuring remained high, and the risk of banks’ assets increased rather than decreased; (iv) since the abilities of performance of some SOEs were not reinforced after the restructuring, the quality of bank assets did not increase much, and some even declined; (v) the ratio of the bank assets repayment was very little, and it led great losses to banks. Besides, several advisable suggestions were given in the report on the policy. For instance, it is suggested that encouraging the transformation of enterprises and protecting the assets of banks be two basic points; bad loans be assumed and transformed by government, enterprises, and banks jointly; and thoughts be widened to activate assets in stock and transfer the risks of present assets in stock through various means, etc.23

**Intensive Handlement of the Bad Assets of State-Owned Banks (SOBs)**

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23 Financial Institution of PBC, Debt Restructuring of SOEs and Assets Protection of Banks.
Affected by the Asian Financial Storm, the central government in 1998 began to put the focus of the Debts-restructuring on the Bank-restructuring in order to resolve the banks’ bad assets that accounted for 20-25% of the banks’ total assets. The central government formulated a series of policies to assist enterprise restructuring such as spreading moderately the mechanism of directing bank and debt-equity swap practice, etc.

Under the impact of the expansionary public finance policies these years, the debt scale and the debt structure of the central government formed over a short time have made people anxious. The financial resources that can be used directly for relieving the distress of enterprises and restructuring the banks are very limited, and the practice that dispatching the non-finance resources through administrative measures is not as rapid and effective as before due to the legal regulations. In 1998, the Ministry of Finance issued special state-bond of RMB 260 billion in order to make up one half of the bad debts of the four commercial banks in the year. After that, the Ministry of Finance invested RMB 40 billion in 1999 to set up four Financial Assets Management Companies (AMC) to take over the bad assets (RMB 1200 billion) hived off from the corresponding state-owned commercial banks and loaned before the end of 1995. The Ministry of Finance hoped that the AMC could promote the reform and relief of the SOEs while activating the bad assets. It was virtually the beginning of using the state assets in stock (bank resources) in a large scale.

Among the 601 enterprises recommended to the AMC and Development Bank by SETC, there are 508 enterprises decided to carry out debt-equity swap, and the total number of the debts amounted to RMB 408 billion and accounted for 29%of the loans (worth RMB 1393.9 billion) hived off from the commercial banks and the Development Bank. By the end of the first half of 2001, the State Council has approved 483 enterprises to carry out the debt-equity swap after the joint examination of SETC, the Ministry of Finance and the People’s Bank of China. The total involved debts for equity swap amounted to RMB 294 billion. And there are 60 new companies among the 483 enterprises that have been registered in accordance with the law.24

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However, the debt-equity swap practice is more like a kind of administrative plan. In the 90% of those agreements, the enterprises were required to buyback all the stock equity within 5-7 years and the local governments were demanded to promise that the enterprises must be separated from the functions of running the social welfare business. But in fact these demands are difficult to be carried out. However, with the primary business goal of preserving the assets and decreasing the losses as much as possible, the AMC made great efforts to take over and deal with the bank’s bad assets with the strong support of the central government. In November 2000, the Rule of the Finance Assets Management Company issued by the State Council strengthened the status of the AMC in the aspects of the business scope, the preferential policies and the protection of the legal rights. Moreover, the headquarters of each commercial bank had the right to dispose and use the most reserve funds for the bad debts themselves with the modification of the CSOP in 1999. Besides, the Ministry of Finance made the limitation flexible at the beginning of 2001, which formerly required that the reserve funds for the bad debts be effectively capped at 1% of the portfolio. The commercialization of the state financial creditors has built up the creditors’ motivation of participating in the enterprises’ debt restructuring, strengthened their status in the enterprises’ debt restructuring and promoted the market operation of such aspects as the capital resources of the debt restructuring, the adjustment of the debt relationships, the decrease and share of the losses in the restructuring, and the loss allocation after the restructuring. For example, Shanghai sub-branch of the Bank of China was an example that the state-owned bank could transfer its claims to stock-holding bank when it transferred its loan contractual claims worth 100 million to Shanghai Sub-branch of Guangdong Development Bank in August 1998. The practice of the claim auction and judicial auction of incorporated stock also took place in Shanghai. At the same time, in accordance with the fast growth of citizens’ income and deposits in our country in the past 20 years, the central government is continuously developing the capital market, encouraging the enterprises to finance directly, and letting the non-governmental capital help the unlisted enterprises which have good economic benefits and potential of development but have been bothered by the high indebtedness. For example, Nanning Chemical Co. Ltd. is the first unlisted company issued 150 millions convertible bonds formally in August
There is another question concerning the debt-equity swap practice with administrative plan characteristic that the range of application is extremely limited. There are more than 100 thousands SOEs all over the country, but the number of the enterprises which could carry out the debt-equity swap was less than 5%. Ten thousands of the middle and small-sized local enterprises would not like to wait for death. The local financial resources were also limited because the local governments have no right to issue the public bonds. Restricted by the laws and guided by the polices, many local governments had to seek for more flexible approaches to handle individual cases within the framework of the law in accordance with the debt structure of each enterprise. Enterprises and governments began to attach importance to the interests of the financial creditors and divert their attention on the capital market and title market, while emphasizing on the satisfaction of the society’s claim such as the claim of the workers to be settled. Some local governments now are not confined to settling the debts once for all any more and they are seeking actively for the optimization of assets, expansion of capital and long-term benefits together with the creditors. Sometimes the participants of the restructuring include the investors who are not native to the locality such as foreign businessmen and nonnative businessmen. As a result, some new approaches of debt restructuring come into being. We can find an epitome of the developmental tendency from the “Changchun Approach” and new cases of other places, which will be introduced in the following report.
II. Changchun Approach: Survey and Evaluation

1. General Survey

Background of Changchun Approach

Changchun City, located in Northeast China, is an old industrial city with the majority of stated-owned enterprises (SOE) and assets. In the past two decades, the local SOEs endured their hard times because of heavy-burdened debts, redundant workers, low quality assets, inflexible management system, obsolete technology and equipment. And the debt burden was the key factor to hinder the enterprises from restructuring assets, obtaining new technology and improving management system. But among their fixed assets many Changchun’s SOEs had profitable assets which could produce marketable goods. Only because of their debt burden and lack of money, the SOEs could do nothing but put the profitable assets aside. Thus the SOEs were in insolvency, the trademarks and names of the SOEs were forgotten, and the market resources were lost. In the end, the unavoidable consequence was assets wasting, bankruptcy, unemployment, and credit losing.

In 1995, Changchun City began to look for ways to rescue the profitable assets of insolvent SOEs. At the beginning, Changchun used administrative power to hive the profitable assets off from the old enterprises, the approach popular at that time, and registered new companies. But soon they found that their practice was against law and there was no way to cut the joint liability between the new enterprises and the old ones, so that the profitable assets could not get rid of the former debts inevitably. Thus, since 1996, a new approach, so-called “Purchase-Sale Restructuring” (PSR), came into being. Under the mediation of Changchun Government, some SOEs negotiated with banks (the main creditors) for rescuing the profitable assets and restructuring debts of the SOEs. Some successful cases appeared after 1997.

In 1999, through summing up the past experience, Changchun proposed three principles in enterprise assets and debt restructuring: (i) capital
marketing and floating principle; (ii) law abiding principle in the procedure of assets transfer; and (iii) principle of protecting creditors at the highest degree when actively negotiating with creditors. Following the principles, a set of relatively complete restructuring approach has gradually been created. Before July 2001, there were about 40 Changchun’s SOEs adopted the approach to restructure themselves and some were successful. In 2000, the officials from the State Economy and Trade Commission went to Changchun several times for survey and study, and some local governments also sent people to Changchun to learn the experience. Therefore, this approach, so-called locally “Purchase-Sale Restructuring” (PSR) and nationally “Changchun Approach”, began attracting people’s attention form other places of China as well as the world. In July 2001, a team composed of scholars and specialists from Beijing and Hong Kong investigated and studied “Changchun Approach” in Changchun City. Before that, a paper by Professor Wang Weiguo on “Changchun Approach” received attention and positive comments at an international forum in Vancouver, Canada.

The Basic Features of “Purchase-Sale Restructuring”

Based on our research of typical cases and description by Changchun government, some banks and enterprises, we can sum up the basic points of PSR in Changchun as follows:

- The old enterprise who will adopt PSR shall be a SOE which is in insolvency but has profitable assets by which profits can be produced.
- Before PSR, the government should set up a new company, usually a wholly stated-owned company. The investment is often in the form of cash, sometimes plus the right of using land. After assets transaction, the company shall gradually covert into a multiple-shareholder company.
- The new company purchases profitable assets from the old enterprise. A relatively typical transaction arrangement is that the new company, the old enterprise and the primary creditors, (usually a bank who has two thirds of claims of the total debts of the old enterprise), enter into an agreement in a package concerning the old enterprise’s profitable assets valuation and transfer, and the sale of the assets and debt payment on the basis of full negotiation. The framework of the agreement can be illustrated in the following graph:
Graph 2-1  Assets Transaction Arrangement in PSR

The transaction shown by the above graph mainly includes four stages: (1) The bank provides a loan to the new company to buy the profitable assets from the old enterprise, and the loan is almost equivalent to the assessed price of the profitable assets. (2) The old enterprise transferred its profitable assets to the new company at the contractual price. (3) The new company gives consideration to the old enterprise by the loan provided by the bank. (4) The old enterprise uses the money obtained to pay debts to the bank.

- In the practice of the above assets transaction, the following measures are usually taken:
- Assessing the old enterprise in every aspect, mainly in profitable assets and product market. The targeted enterprise shall present a plan of restructuring. And the plan shall be discussed and proved by the relevant government departments.
- Abiding by law strictly in assets transaction. Firstly, the valuation of profitable assets shall be done by an authorized body. And the valuation result shall get consent of the Administration of State-owned Assets and the creditor (usually the primary creditor). Secondly, the plan shall get consent of the workers’ congress of the old enterprise. Thirdly, the transaction shall be done in the Center of Title Transaction. After the agreement becomes effective, both parties should deliver assets and money to each other according to the list of assets valuation.
- Resolving the problems of workers’ thoughts by the Communist Party of China and the Trade Union to obtain workers’ support and participation.
- The majority of workers from the old enterprise shall work for the new company, and shall sign a labor contract with the new company.
- The new company gets floating assets in various ways and uses the assigned profitable assets to produce marketable products. Thereafter, it
shall reform its property right system and covert itself into a multi-shareholder enterprise such as share-issuing enterprise, shareholding cooperative enterprise, enterprise group, sino-foreign joint venture and cooperative enterprise.

- Proper disposition of the old enterprise’s residual assets. To those that are not effective for operation, bankruptcy shall be conducted. Those that are still effective for operation may remain. The new company may support the old enterprise in business or restructure it later at proper time concerning the residual assets.

**The Effects of “Purchase-Sale Restructuring”**

We can see that Changchun’s PSR has achieved “multi-wins” for the debtor, local government and primary creditor. In general, this kind of restructuring has the following effects:

(5) The profitable assets are hived off from the debts of the old enterprise and continue to operate and earn profits. And the new company who enjoys better goodwill and financial ability can operate the profitable assets well and expend its operation by issuing shares, obtaining foreign investment, and merger, etc.

(6) The bank, as the primary creditor, has new credit to the new company by issuing loans. And the credit is believed a good one. At the same time, the bank has eliminated a part of bad debts with the sum equal to the payment by the old enterprise Thus the bank was repaid much more than that acquired through the old enterprise’s bankruptcy with its profitable assets (often 0-10% of total claims).

(7) The employees of the old enterprise retain their employment and their wages in the new company are usually higher than before.

(8) With much less money, the government fulfills renewal of state-owned assets, maintenance of employment, and social stability, and can get taxes from the new company.

2. Typical Cases
Case 1: Changchun Special Vehicle Factory

In this case, the restructuring transaction of the new company purchasing the high quality assets from the old enterprise began in December 1996 and ended in August 1997. The transaction involved total bank claims of RMB 45,840,000, renewed profitable assets of RMB 9,560,000 and settled all the on-the-post employees of the old enterprise. Now the new company is going well and enjoying a good credit. Changchun Special Vehicle Factory (CSVF) has been regarded as a model in the practice of “Purchase-Sale Restructuring” for the state-owned enterprises in Changchun City.

A. The Basic Conditions Before Restructuring

CSVF is a state-owned enterprise formed in 1993 by a merger of Changchun Lift Truck Works and Changchun Remolded Vehicle Works. CSVF earned profits at the beginning. But because of the obsolete equipment, backward management and no proper adjustment to market changes, CSVF gradually turned into an enterprise in deficit. In 1996, CSVF faced the following difficulties:

1. The use of water, electricity, telephone, bank accounts and checks were stopped.
2. Its total assets were RMB 95,000,000 and total liabilities were RMB 130,000,000. The ratio of liabilities to assets was 137%.
3. There were no basic guarantees of living and medical treatment for 1,460 employees and 290 retired workers.
4. The workers appealed frequently to local government for help.
5. CSVF was involved in a lot of litigation.
6. It had been in the bankruptcy list in which the enterprise could adopt the State Council’s new bankrupt policy. Only because of Changchun City’s financial problem did CSVF not enter into the proceedings of bankruptcy.

The enterprise, however, had some conditions to be recovered. Firstly, CSVF had profitable assets. If its huge debts were relieved, it could produce marketable vehicles. Secondly, it had lots of skilled technicians and workers. They would play a very important role in CSVF’s recovery. If the enterprise were bankrupt, they would become almost useless in society. Thirdly, all
related parties would like to avoid CSVF’s bankruptcy. Once bankruptcy was conducted, it would make the enterprise’s equipment worthless, the workers unemployed, the local government difficult in finance, and most claims unpaid. The last was that the practice of “Purchase-Sale Restructuring” in Changchun city in 1996 threw a light on CSVF.

In July 1997, CSVF had total bad assets RMB 66,340,000 and total liabilities RMB 130,510,000. The ratio of liabilities to assets was 196.72%. Among the total debts, the loans and interests were 41%, represented RMB 53,440,000, which included loans RMB 43,120,000 from the Industrial and Commercial Bank of China, RMB 5,420,000 from Construction Bank of China, RMB 500,000 from Bank of China, RMB 1,500,000 from Credit Cooperative and RMB 2,900,000 from others.

B. The Process of Restructuring

The Process of Restructuring took the following steps:

- **Negotiating with banks.** From the end of 1996, under the mediation of Changchun Economic and Trade Commission, CSVF negotiated with the Industrial and Commercial Bank of China for several times. In June 1997, the bank finally agreed to CSVF’s restructuring, and agreed to provide loans to the assets buyer in this restructuring transaction.

- **Starting a new company.** In August 1997, Changchun Bureau of Machine Industry started Changchun Special Vehicle Company (CSVC) with money and the right of using land amounted to RMB 11,900,000. The operating groups of CSVF and CSVC were independent to each other.

- **Assets buy-out.** In August 1997, CSVC bought profitable assets of RMB 9,560,000 (in which fixed assets were RMB 6,362,000 and floating assets RMB 3,198,000) from CSVF with the loans provided by Industrial and Commercial Bank of China (RMB 8,430,000) and Construction Bank of China (RMB 1,130,000).

- **Paying debts to banks.** After having received the money of RMB 9,560,000 from CSVC, CSVF repaid its debts to bank creditors: Industrial and Commercial Bank of China (RMB 8,430,000) and Construction Bank of China (RMB 1,130,000). The rate of repayment to the two banks was 20%. The rest debts were still assumed by CSVF.
• **Settling the old enterprise’s workers.** The 518 workers of CSVF on the post at the time of restructuring were employed by CSVC. The 150 workers who were absent from the post then, including those who found job themselves, who left their post voluntarily but retained the employment relations, still remained at the old factory.

• **Disposing the old enterprise.** After the restructuring, the residual assets and liabilities were still taken by CSVF. Its business gains were totally used to repay the loans, the unpaid taxes and other debts. Nearly 300 retired workers of CSVF were looked after by CSVC on its own cost.

C. The New Company’s Conditions After Restructuring

1. After restructuring, CSVF had total assets RMB 50,000,000 and total liabilities RMB 25,000,000. The ratio of liabilities to assets was 50%. Thus its financial structure and credit are relatively good. At the beginning of 2000, CSVC’s credit rating was granted A and got a loan of RMB 500,000 from the bank. At the end of July 2001, CSVF had total assets RMB 53,170,000 and total liabilities RMB 29,950,000 (including debts to banks RMB 10,430,000). The ratio of liabilities to assets was 56%.

2. The output value of CSVC was RMB 7,800,000 in 1997. But because it just resumed to production, it was in deficit in the year. Since 1998, the new company has been in good circulation. In 1998, CSVC ’s output value was RMB 16,000,000 and the earned profits were RMB 6,000. In 1999, its output value was RMB 32,000,000 and the earned profits were RMB 10,000. In 2000, its output value was RMB 60,000,000 and the earned profits were RMB 1,280,000. It is estimated that there will be RMB 70,000,000 of sale revenue and RMB 1,500,000 of profit and tax.

3. From August 1998 to the end of 2000, CSVC totally achieved sale income of RMB 57,750,000 and profits of about RMB 1,000,000 after taxes of RMB 370,000.
Table 2-1 Revenue, Profit and Tax of CSVC

<table>
<thead>
<tr>
<th>Year</th>
<th>Sale Revenue</th>
<th>After Tax Profit</th>
<th>Paid Tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>91</td>
<td>26</td>
<td>—</td>
</tr>
<tr>
<td>1998</td>
<td>812</td>
<td>0.5</td>
<td>0.6</td>
</tr>
<tr>
<td>1999</td>
<td>1803</td>
<td>11</td>
<td>21</td>
</tr>
<tr>
<td>2000</td>
<td>3049</td>
<td>89</td>
<td>15</td>
</tr>
<tr>
<td>2001</td>
<td>7000 (estimated)</td>
<td>100</td>
<td>50</td>
</tr>
</tbody>
</table>

4. The new company continually adjusts itself to market requirements and betters its product structure. Now it is producing 9 series and about 60 types of special vehicles. Its compact garbage truck has adopted advanced technology from German and was granted “Nationally New Product” by the State Economic and Trade Commission.

5. Since August 1997, the interests of the above loans from banks have fully been paid on time.

6. When CSVC founding in 1997, its bank-granted credit rating was B so that it was unable to get loan and its development should rely on its own accumulation. Along with its growing, the bank raised its credit rating to AA, 5 level of advance, and met the requirement for getting loan.

7. In 1997, the average monthly wages in CSVC were about RMB 300. In the first half of 2001, however, the average monthly wages reached to RMB 700 and the worker’s highest monthly wages were over RMB 1,700.

8. In order to solve the problems of single investor and non-standardized institution, CSVC is carrying out a plan to covert itself into a stock-holding corporation. At the same time, based on CSVC, Changchun Huanling Special Vehicle Group is going to be formed.

D. Other Information

In the process of restructuring, the participants were CSVF, CSVC, Industrial and Commercial Bank of China and Construction Bank of China. Changchun Economic and Trade Commission acted as a general mediator. Except for the Industrial and Commercial Bank, other creditors did not know the restructuring until it was completed.
Case 2: Changchun Printing Machine Factory (CPMF)

In September 1998, the new company purchased the profitable assets from the old enterprise and began to operate. The restructuring involved bank debts of RMB 54,490,000, activated profitable assets of RMB 42,560,000 and settled about 70% of the old enterprise’s employees. Now the new company is vivid with life and regarded as a successful case in the practice of “Purchase-Sale Restructuring” in Changchun city.

A. The Basic Conditions of the Restructuring

CPMF was originally built in 1956. As a medium-sized enterprise and the largest printing machine factory in Jilin Province, it had 111,000 square-meter land and 1,371 employees (including retired employees of 386) in August 1998. It was governed by Changchun Bureau of Machine Industry and was one of the experimental enterprises to build modern enterprise system. It was entitled to the right of import and export by Ministry of Foreign Trade and Economic Cooperation in 1993. The enterprise was also in the leading position in China in regard to the ability to produce, design and product quality. Nevertheless, the enterprise bore a heavy interest burden of RMB 4 million per year during the period of the National Eighth Five-Year-Plan and the Ninth Five-Year-Plan because of a loan of RMB 30,400,000 used to improve the factory’s technology and equipment. In addition to many short-term loans and bad assets losses, CPMF carried total liabilities of RMB 78,530,000 in book entries (but actual liabilities were RMB 91,130,000) and total assets of RMB 78,270,000, and its actual ratio of liabilities to assets was 116% by the end of 1997. The total liabilities of RMB 78,530,000 in book entries included bank loans of RMB 55,570,000, workers’ wages RMB 2,630,000, welfare funds RMB 330,000, housing funds RMB 970,000, taxes RMB 1,630,000 and other accounts payable RMB 17,400,000. Among those, the Industrial and Commercial Bank of China had claims of RMB 54,490,000, about 69% out of CPMF’s total liabilities in book entries.

By the end of 1996, CPMF’s deficit amounted to RMB 4,560,000 and had no ability to pay banks’ interests. It lost its credit in banks and could not get any loan from them anymore. Thus it had no capital to maintain
production though the enterprise's products were still welcomed in both international and home market. If the enterprise had waited passively under that condition, the result would have been bankruptcy.

In order to improve the enterprise’s capital structure, reduce the unreasonable burden, relieve it from difficulty, maintain state-owned assets, cut down creditors' losses and avoid pushing all the employees to the society, CPMF executed Purchase-Sale Restructuring through negotiation with the primary creditor with the help of the government.

B. The Process of the Restructuring

The restructuring of CPMF followed the following steps:

- **Starting a new company.** The Changchun Government started Changchun Printing Machine Company, Ltd. (CPMC) by cash investment of RMB 500,000 in September 1998. It was a wholly state-owned company.

- **Buying out assets.** CPMF, CPMC and the primary creditor, Industrial and Commercial Bank of China, reached an agreement in relation to “Purchase-Sale Restructuring”. Thereafter the agreement got the approval of the Workers’ Congress. The selection and valuation of profitable assets were determined after getting the consent of the main creditor. In this case, CPMF had total profitable assets of RMB 42,560,000 including floating assets of RMB 9,560,000, fixed assets of RMB 21,920,000 and constructing projects of RMB 7,910,000. Among the total profitable assets, CPMC bought out the profitable assets of RMB 24,280,000 with the loan provided by Industrial and Commercial Bank of China (the primary creditor of CPMF). In the process of assets purchase such as assets valuation, delivery and transfer and authorization from Administration of Stated-owned Assets, the legal transfer proceedings were followed strictly. The Changchun Committee of Economic and Trade had made lots of efforts to guarantee the proceedings to go smoothly when necessary.

- **Paying debts to the bank.** After having received the money from CPMC, CPMF repaid its debts to its primary creditor, Industrial and Commercial Bank of China. The bank's rate of repayment was 44.6%.

- **Settling the old enterprise's employees.** 960 employees of CPMF were
accepted by CPMC. Except for the departments who continued operating in order to serve CPMC, other departments of CPMF stopped operation. About 20 workers were still in CPMF to deal with the rest problems. The settlement rate was 70%.

- Disposing the old enterprise. CPMF entered into bankrupt proceedings in June 2001.

C. The New Company’s Conditions After Restructuring

1. In order to raise floating capital to begin the production of CPMC, Industrial and Commercial Bank of China provided a loan of RMB 2 million to it after the restructuring. CPMC paid the bank’s interests on time. And by the end of 2000, CPMC had paid total interests of more than RMB 1 million. Thus CPMC is getting along well with the bank.

2. In 1999, CPMC achieved sale income of RMB 33,200,000 and profits of RMB 310,000 after taxation of RMB 3,080,000. In 2000, CPMC achieved sale income of RMB 30,220,000 and profits of RMB 810,000 after taxation of RMB 3,080,000. The new company had total assets of RMB 80,000,000 and total liabilities of RMB 52,320,000 by the end of July 2001. Thus the ratio of liabilities to assets was 65.4%.

3. At the end of 1999, CPMC held 60% shares of Changchun Weixin Casting Company, Ltd. located in the suburb, by the way of land exchange for shares.

4. CPMC leased CPMF’s painting workshop and planned to purchase it at the time of bankruptcy. The CPMF repaid the wages of the rest personnel and other costs by the rent.

5. After the restructuring, CPMC set up the corporate organizational structure in accordance with the Corporation Law, strengthened the inner management, executed the reform of organization and salary, constituted three centers (Financial and Accounting Center, Goods and Materials Store Center, and Personnel Resources Center) and started the practice of negotiating salaries with technicians.

6. In February 2001, the state-owned capital was withdrawn from CPMC and CPMC transferred itself from the wholly state-owned company into a limited liability company with multiple shareholders. The group of operators held 30% shares out of the total, the individual employees held 55% and the collective of employees held 15%. The shares of the group
of operators were mainly bought in cash from Administration of Stated-owned Assets at a favorable price and these could not be transferred in 5 years unless the shares were given back when he or she violates the law or leaves the incorporation. Among the shares held by the group of operators, the main operators held 30%. The investments of individual employees’ were offset by the sum of compensation of RMB 15,000,000 for the status change from workers of state-owned enterprise to workers of other enterprises. The employees were issued with inner share certificates. And the shares should not been transferred within 3 years unless the transaction was approved by the board of directors. The employees’ collective shares were set aside for special purpose. These could be used to solve the retired employees’ problems of welfare, medical treatment, burial fees and so on.

7. CPMC has developed 10 new products by now. It is negotiating positively with Walenbel Company (the second largest printing machine company in German) for cooperation to pursue a better future.

8. The new company is leasing equipment from the old enterprise at RMB 20,000 rent per year.

9. CPMC has deepened its inner reform by dismissing redundant workers, setting up the Store Center and Financial Center, and reforming wage system and so on. The workers’ wages are higher than before as a whole.

D. The Effects of Restructuring

(1) In contrast to the old enterprise, the financial condition of the new company has a great change. This can be illustrated by table 2-2.
Table 2-2  Contrast Before and After Restructuring

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Assets</strong></td>
<td>7827</td>
<td>4256</td>
<td>5833</td>
</tr>
<tr>
<td><strong>Profitable Assets</strong></td>
<td>3939</td>
<td>4256</td>
<td>5833</td>
</tr>
<tr>
<td><strong>Debt to Primary Creditor</strong></td>
<td>5557</td>
<td>2428</td>
<td>3435</td>
</tr>
<tr>
<td><strong>Liabilities-to-Assets Ratio (%)</strong></td>
<td>116</td>
<td>66</td>
<td>59</td>
</tr>
<tr>
<td><strong>Earned Profits (RMB 10,000)</strong></td>
<td>-32</td>
<td>26</td>
<td>81</td>
</tr>
</tbody>
</table>

*Not including the data of Changchun Weixin Casting Company, Ltd.

(2) The primary creditor has recovered the loan of RMB 24,280,000 and the repayment ratio of credit was about 45%, which is much above the usual ratio of 10% in bankruptcy. In addition, the creditor has a high quality claim of RMB 24,280,000 to CPMC, (which is secured by the fixed assets, the interests are paid monthly according to the contract, and so the claim belongs to good assets).

(3) The government has relieved a state-owned enterprise with less money and avoided the unemployment of 1371 workers. Moreover, the government has received taxes of RMB 6,160,000 from the new company in 1999 and 2000.

(4) After restructuring, CPMC was claimed debts by non-bank creditors but without involving litigation.

(5) When CPMF entered into the process of bankruptcy, there were more than 100 creditors and more than RMB 8 million small and medium-sized claims, which were about 20% out of total liabilities. It is estimated that the claims are probably paid by nothing because CPMF has only a few assets and has difficulty liquidating them.

**Case 3: Changchun Vehicle Lamp Factory**

In April 1998, the new enterprise completed the purchase of the old enterprise’s profitable assets. The total debts of the bank involved in this restructuring are worth RMB 60,248,000. The restructuring has activated the profitable assets worth RMB 21,580,000, and settled about half of the old enterprise’s staff and workers. A series of capital restructuring was carried...
out after the restructuring such as drawing new capital, expanding the scope of the business, and activating the profitable assets. These have brought about considerable economy benefits.

A. The Basic Situation Before Restructuring

Changchun Vehicle Lamp Factory grew out of the Changchun State-operated Agricultural Machinery Accessories Factory set up in 1968, which was a conveyance enterprise of Changchun No.1 Car Manufactory Factory. In 1994, the No.1 Car Manufactory Factory began the group expansion, and asked all of its conveyance enterprises to take a relevant modification. The Vehicle Lamp Factory spent more than RMB 50,000,000 (including more than RMB 37,000,000 of the bank’s loan) on the transformation of the technology and equipment, and increased the number of workers accordingly so as to cooperate the No.1 Car Manufactory Group’s car production and explore the existence and development of the enterprise. However, the aim of the No.1 Car Manufactory Group to produce 100,000 cars every year did not come true because of the poor marketing (it produced only 8,000 to 10,000 cars every year in fact), and the price was also lower than expected. This situation directly affected the Vehicle Lamp Factory. The vehicle lamp’s sales price was forced to decrease, the number of the sales was reduced, the factory’s utilization of capacity was not enough, and the rate of the output to the input was very low. In 1996, the total losses were RMB 8,510,000.

At the end of 1997, the factory had 767 workers. The losses in the year amounted to RMB 8,510,000, and the accumulated debts in total were more than RMB 20,000,000. Before the restructuring in April 1998, the total assets were RMB 91,840,000, while the total liabilities were RMB 104,484,000. The liabilities-to-assets ratio was 114% in fact. The proportion of the bad assets, which was accumulated in the years, was very high. The liabilities were comprised of the loan principal and interests of the Industrial and Commercial Bank Changchun Sub-branch (worth RMB 60,248,000), the loan principal and interests of the Construction Bank Changchun Sub-branch (worth RMB 5,000,000), the loan principal for policy consideration of Changchun Planning Commission (worth RMB 5,000,000), the pooled money owed to the workers (worth RMB 3,090,000) and the medical
expenses (worth RMB 250,000) etc. The Industrial and Commercial Bank’s claim accounted for 57% of the total liabilities.

At the same time, the factory’s shortage of the capital was so serious that it could not develop the new production or seek for joint-venture or cooperating partners because it could not get loans from the banks any more due to the decline of the factory’s financial credit and the fact that the payment of the purchasers was always defaulted. It was also difficult for the factory to have even a few complete set of orders because the No.1 Car Manufactory Group evaluated the Vehicle Lamp Factory as a Grade C Conveyance Enterprise from the original Grade A Conveyance Enterprise. Under these circumstances, the factory fell into dire straits and could not make up deficits by itself.

In order to extricate itself from the difficult position, with the negotiation and efforts of the three parties of the government, the enterprise and the bank, the Vehicle Lamp Factory began to readjust its stock assets, hive off its profitable assets through the Purchase & Sale Debt-restructuring and open up a path for the augment of the assets and expand the market depending on the profitable assets.

B. The Process of the Debt Restructuring

The process of the debt restructuring of the Vehicle Lamp Factory is as follows:

- Setting up a new enterprise. Changchun municipal government invested the right of using the land (worth RMB 3,330,000) to set up Changchun Vehicle Lamp Co. Ltd. (hereinafter also known as Changchun Vehicle Lamp Co.) in April 1998.

- Buying out assets buy-out and repaying debts. On the basis of the negotiation of all parties, Changchun Vehicle Lamp Co. obtained a loan of RMB 21,580,000 from the Industrial and Commercial Bank Changchun Sub-branch to purchase the Vehicle Lamp Factory’s profitable assets worth RMB 21,580,000, and the Industrial and Commercial Bank Changchun Sub-branch got the right to mortgage the assets at the same time, which was passed by the Vehicle Lamp Factory’s workers’ congress and granted by the administrative
department in charge. The Vehicle Lamp Factory spent RMB 21,580,000 received from the Changchun Vehicle Lamp Co. paying for the debts owed to the Bank. The rate of repayment was 36%. And the No.1 Car Manufactory Group evaluated the Vehicle Lamp Co. as a Grade B Conveyance Enterprise according to the capacity of production and the financial situation of the Changchun Vehicle Lamp Co.

- **Converting to a joint venture.** At the beginning of 1997, the Vehicle Lamp Factory together with German Haila Co. and Hongkong Xunjie Co. set up a joint venture as Changchun Haila Vehicle Lamp Co., Ltd. (hereinafter known as Changchun Haila Co.), mainly specializing in manufacturing car lamps. However, the Vehicle Lamp Factory’s subscribed capital had not been ready until April 1998 due to certain reasons. After purchasing the assets, Changchun Vehicle Lamp Co. took over the Vehicle Lamp Factory to subscribe capitals (RMB 15,750,000) and became one of the shareholders of Changchun Haila Co. (with the possession of 25% shares), which was agreed by the foreign partners and granted by the administrative department in charge.

- **Setting up a new joint venture.** In October 1998, Changchun Vehicle Lamp Co. together with Changchun Haila Co. invested RMB 20,000,000 to set up Changchun Changhai Vehicle Lamp Co., Ltd. (hereinafter known as Changhai Co.) mainly specializing in manufacturing lorry lamps. Changchun Vehicle Lamp Co. possessed 30% shares of Changhai Co. with the cooperative terms that it provided the technical staff, special equipment and intangible capital such as brand and market, (this means that Changchun Vehicle Lamp Co. would not manufacture lorry lamps), worth RMB 15,750,000, etc.

- **Setting up a new joint venture again.** At the end of 1999, Changchun Vehicle Lamp Co. together with Taiwan Pingxing Industry Co. Ltd. (Taiwan Pingxing Co.) and Xiamen Jilu Spares Co. (Xiamen Jilu Co.) invested RMB 15,000,000 to set up Changchun Yongsheng Industry Co. Ltd. (hereinafter known as Yongsheng Co.) with the land-using right and factory buildings as subscribed capital of Changchun Vehicle Lamp Co. and the cash and equipment as subscribed capital of Taiwan Yongsheng Co. and Xiamen Jilu Co. Changchun Vehicle Lamp Co. possessed 20% shares of Yongsheng Co.

- **Settling the workers of the old enterprise.** 378 workers of the Vehicle Lamp Factory are working in Changhai Co. now, and 27 workers are in
Yongsheng Co. The rate of settlement is 53%.

- **Selling the assets and brewing for new joint venture.** Changchun Weihong Group which grew up from Changchun Machinery and Electrical Equipment State-owned Assets Management Co. once rented the injection & moulding workshop for manufacturing WH-J electric heat water bowls. The group now purchased the workshop and set up Changchun Weihong Group Automatic Equipment Co. The group and Changchun Vehicle Lamp Co. are brewing for a new joint venture currently.

- **Disposing the old enterprise.** In May 2000, the Vehicle Lamp Factory went bankrupt according to the law. There were 389 workers left in the factory including 229 retired workers. The total assets of the factory were RMB 64,169,000, most of which were unprofitable assets such as mold-apparatus of the previous production and the products kept in stock and could not be sold. The total liabilities were RMB 78,932,000. The liquidation income of the bankruptcy assets worth RMB 16,493,000, except costs of bankruptcy proceedings, was used for settlement of the workers. The creditors got nothing in the bankruptcy distribution. Before the old enterprise went bankrupt, most of the creditors were called together and informed of the situation, which the creditors showed their understanding and sympathy for it. The process of the bankruptcy was ended in May 2001.

C. The Situation of the New Enterprise After Restructuring

1. The economic benefit of Changchun Vehicle Lamp Co. is increasing with the formation of the investment structure and the expansion of the business after purchasing the profitable assets from the Vehicle Lamp Factory. The profits of the Vehicle Lamp Factory and Changchun Vehicle Lamp Co. since 1997 are as follows:
### Table 2-3 Profits of Vehicle Lamp Factory and Changchun Vehicle Lamp Co. Since 1997

Unit: RMB 10,000

<table>
<thead>
<tr>
<th></th>
<th>1997</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001 (estimated)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Vehicle Lamp Factory</strong></td>
<td>-851</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Changchun Vehicle Lamp Co.</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dividends from Changchun Haila Co.</td>
<td>Slight loss</td>
<td>&gt;200</td>
<td>&gt;320</td>
<td>&gt;400</td>
<td></td>
</tr>
<tr>
<td>Dividends from Changhai Co.</td>
<td>-260</td>
<td>slight loss</td>
<td>26.4</td>
<td>&gt;240</td>
<td></td>
</tr>
<tr>
<td>Dividends from Yongsheng Co.</td>
<td></td>
<td>&gt;200</td>
<td>&gt;416</td>
<td>&gt;710</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>-260</td>
<td>&gt;200</td>
<td>&gt;416</td>
<td>&gt;710</td>
<td></td>
</tr>
</tbody>
</table>

Note: At present, the liabilities-to-assets ratio of the Changchun Vehicle Lamp Co. is 87%, and since the profits were used to expand its investment, there are some unpaid interests owing to the Bank.

2. Changchun Vehicle Lamp Co. expanded its capital and market continually by the joint venture and absorbed RMB 59,250,000 investment outside after obtaining the valid assets from the Vehicle Lamp Factory through the Purchase-Sale Debt Restructuring. The scale of the total investment of the affiliate companies including Changchun Vehicle Lamp Co., Changchun Haila Co., Changhai Co. and Yongsheng Co., amounts to RMB 101,830,000. (It would reach to RMB 123,410,000 plus the assets RMB 21,580,000 purchased with the loan from the Industrial and Commercial Bank.) The structure of the investment and property is as follows:
Municipal Government  Industrial and Commercial Bank

3.3 million investment  21.58 million loan

Changchun Vehicle Lamp Co.  25% share by German Haila Co.  51% share
15.75 million investment

HK Xunjie Co.  24% share

Changchun Haila Co. (63 million investment)

20% share by 6 million investment

30% share by 3.3 million investment

Changhai Co. (20 million total capital)

Yongsheng Co.  15 millions total investment

Xiamen Jilu Co.

Taiwan Pingxing Co.

Chart 2-2  The Structure of Investment and Property of Changchun Vehicle Lamp Co.

3. A new product was launched into the market in June, 2001, which was developed in 2000 and named as WH Serial Electrical Boiler by Computerized Automatic Control, and has brought about the sale income of RMB 790,000 and profits of more than RMB 200,000 to Yongsheng Co.

4. The Vehicle Lamp Factory’s workers have a better employment environment and a higher level of salary after they worked for the joint ventures. The average monthly salaries of the Haila Co.’s workers are more than RMB 1,400, and the average monthly salaries of the Changhai Co.’s workers are about RMB 700.

5. The new Corporation (Changchun Vehicle Lamp Co.) is still solely state-owned Corporation.

6. Changchun Vehicle Lamp Co. came across certain debt claims by the creditors after the Debts Restructuring. Because the Vehicle Lamp Factory owed RMB 430,000 to Beijing Youchang Bulb Management Co. at the end of 1997, Changchun Vehicle Lamp Co. was decided to take the joint and several liability as a co-defendant by the People’s Court,
Luyuan District, in Changchun at the beginning of 1999. Changchun Vehicle Lamp Co. enforced the judgment instead of appealing to a higher court for the sake of production.

**Case 4: Changchun No.2 Machine Tool Plant**

At the end of 1999, the new enterprise had finished purchasing the profitable assets of the old enterprise. The restructuring involved bank debts RMB 99.71 million, profitable assets RMB 17.69 million, and some equipment was leased and 58% of workers from the old enterprise were settled. One of the characteristics of this case is that when the old enterprise was conducting technology improvement, though the products were promoted, the debts went up too. Thus, the financial distress made the achievements of the technology improvement laid aside and neglected. After the restructuring, the new enterprise has put those achievements into market and got remarkable economic benefits.

A. The Situation Before Restructuring

The No.2 Machine Tool Plant of Changchun (MTP) was set up in 1951. It was one of the major miller machine manufacturers specially appointed by the Ministry of Machine and Industry. It became one of the enterprises belonging to the province in the 1980's. In 1983, the Welding Equipment of Changchun, which had been the No.3 Machine Tool Plant, merged into MTP. Then it was the only plant that produced the friction-welding machine, and it was one of the eight major plants in welding machine industry. At the beginning of the 1990's, MTP was the most profitable plant in the manufacturing industry, and it became one of large taxpayers among the enterprises of Jilin province.

The major products of MTP were miller machine series, friction welding machine series, welding auxiliary machine, special welding machine, special line of production, etc. The miller machine was the fine quality product in Jilin province, and it reached the advanced level in China. MTP has exported products to Southeast Asia, Middle East, South America and other dozens of countries and areas since 1998. Friction welding machine series were named "Save Energy Product" by the Ministry of Machine and Industry. The plant
developed fast in the productivity, scale, staff and workers, and technology level after the third time of technology transformation. And the assets value rose from RMB 18.810 million at the end of 1986 to RMB 1.25 billion. Nevertheless, the plant fell into financial distress, when the plant made technology progress and enlarged its scale, because of the influence of micro economy environment. The business fell into distress, and the main problem was that the sale of the major products was not good and the debts due could not be paid on time, which led to capital shortage, shortage of investment for reproduction, and profits decline.

The number of the workers in the plant was 1,642, in which 1,209 were at work, and 433 retired. The value of total industrial output in 1998 was RMB 7.01 million, the sale revenue was RMB 11.42 million in 1998, and the losses of the whole year were RMB 8.91 million. The total assets in the book entries of the year were RMB 125.387 million, the total liabilities were RMB 121.686 million, and the liabilities-to-assets ratio was 97%.

Since 1997, part of the production began to come to a stop. In 1999, the value of total industrial output was RMB 5.47 million, the sale revenue was 7.68 million, the losses of the whole year were RMB 15.18 million, the accumulative losses were RMB 43.22 million, the bad assets amounted to RMB 32 million, and the liabilities-to-assets ratio was 140.6%. MPT had many debts because the business was in difficulty. By the end of the 1999, the total liabilities were RMB 134.38 million, in which the amount owed to the Industrial and Commercial Bank of China was RMB 99.71 million, unpaid taxes RMB 7.70 million, house accumulation funds RMB 1.43 million, wages of the workers RMB 1.4 million, pooled fund and medical expenses RMB 2.94 million, social insurance fund RMB 2.60 million, and accounts payable about RMB 6 million.

Before the sale of the assets in April 2000, MPT had total assets RMB 84.22 million, the total liabilities in the book entries were RMB 126.15 million (the actual liabilities were RMB 146.03 million), the liabilities-to-assets ratio in the book entries was 150% (the actual ratio was 173.4%), in which the debts owed to the Industrial and Commercial Bank was RMB 1.0611 billion, which was 84% in the total liabilities in the book entries.
Due to the bad economic performance, MPT had still been adopting the wage standard set before 1994. From 1998 to 1999, the average annual income of the workers was RMB 3,100, and the living of the workers was in difficulty. The plant could not pay medical expenses for the workers. Neither could the plant pay pension for the disabled or for the families of the deceased after the workers died for several years. Though there were orders for products, the plant could not deliver goods on time because of lack of floating capital.

B. The Process of the Restructuring

Confronted with the above situation, MTP carried out "Assets Restructuring, Operating on Buy-out". The stages are as follows:

- **Setting up a new enterprise.** The State Assets Management Co. Ltd. of Mechanical and Electrical of Changchun put in RMB 500,000 and the right of using land, the value amounting to RMB10 million, to set up MTP Limited Liability Corporation (MT Co. Ltd.), which was the limited company solely owned by the state.

- **Buying out assets.** MT Co. Ltd. loaned RMB 17.69 million from Changchun Branch of the Industrial and Commercial Bank of China, who is the primary creditor. It used the loan to purchase part of the MTP profitable assets, including floating assets amounted to RMB 10.78 million, fixed assets RMB 7.20 million, and the total amount was RMB 17.98 million. The value of the assets after hive down was 14.1% of the total assets of MTP. During the process of purchasing the profitable assets, the assets were evaluated by Changchun Mechanical and Electrical Equipment of the State Asset Management Co. Ltd. entrusted by MT Co. Ltd. and was examined and approved by the Administration Bureau of State Assets. The transaction also gained consent of the primary creditors and the workers. The whole transaction was executed in the Title Exchange Center. The bank took mortgage on the transferred assets when it provided the loan.

- **Leasing the equipment of the old enterprise.** The new enterprise leased 106 machines of the old enterprise. The annual rent is RMB 5 million, and the lease term is 4 years. MTP Co. Ltd. leased some other
equipment and real estate of MTP. MTP used the rent to pay for the wages of the workers and interests of the loans.

- **Repaying bank debts.** MTP used all the purchase money, which was paid by MT Co. Ltd. amounting to RMB17.69 million and the equipment rent, amounting to RMB 3 million, to pay the debts of the Industrial and Commercial Bank of China. The total amount was RMB 20.69 million. The rate of repayment was 19.5%.

- **Settling the workers of the old plant.** The workers at work in the MTP were 1207. More than 700 workers were accepted by the MT Co. Ltd. The rate of settlement was 58%. Different approaches were adopted to settle the rest of staff and workers, such as arranging them in the reemployment center, getting them retired, and setting up the third industry, etc.

- **Gaining the additional funds by using the land property.** To promote the development of the new corporation, and gain the money to buy the profitable assets, with the support of the government policy, MTP Co. Ltd. adopted the method of using land to gain necessary funds. That is to say, MPT’s right of using the land, which is appropriated by the state, was sold to the MTP Co. Ltd. Then the MTP Co. Ltd. transferred the right of using land to develop real estate. It has gained RMB 1.25 million of revenue. The revenue was distributed as follows: paying RMB 12.07 million for the right of using the land; paying uncompleted construction expenses RMB 33 million; paying debts RMB 1.5 million; paying moving expenses RMB 10 million; appropriating enterprise development fund RMB 40 million, including RMB 20 million for initiating production, and RMB 20 million for developing products; turning over RMB 10 million to the government department responsible for the corporation; and preserving RMB 5 million for the unpredicted expenses.

- **Leasing part of equipment of the old enterprise.** MPT Co. Ltd. leased some of the equipment and buildings of the old plant, and the rent was used to pay for part of the workers’ salaries and interests of the loans.

- **Investing externally.** The new corporation invested RMB 0.1 million and bought shares in the Ruiping Co. Ltd., who had capital of RMB 1 million, and mainly managed the installation projects of the vehicle production line and had enormous potentiality in the technology. The investment has resolved the problem of inadequate design capacity and
surplus production capacity, and increased the processing orders.

- *The current situation of the old enterprise.* MTP is still a legal entity after restructuring, and making use of the residual assets to produce products. It has hived off the Casting Subsidiary Plant and Spray Painting & Packing Subsidiary Plant from administrative department, making them run business independently.

C. The Situation of the New Corporation after Restructuring

1. On the basis of purchasing the assets of the old enterprise, the new corporation has operated completely according to the stipulations in the company law. The enterprise has remarkable improvements in the economic performance. They are manifested in the following three aspects: The management expenses of the new enterprise have been greatly decreased because the reduction of the personnel has reduced the management expenses compared to pre-restructuring; the assets have been optimized and the workers are properly settled. With the production expenses decreasing greatly, the level of profits of the product has a remarkable improvement; financial affairs expenses have decreased greatly.

2. By the end of June 2001, the production and sale situation and the financial affairs were as follows: the sale revenue amounted to RMB6.852 million, the profits of products sale RMB 3.24 million, the total amount of the profits RMB 50,000, the net profits RMB 42,000, the total assets RMB 34.324 million (floating assets amounted to RMB 16.105 million, fixed assets RMB 18.205 million, and intangible and deferred assets RMB 14,000), and the total debts RMB 23.076 million, and the liabilities-to-assets ratio was 67%.

3. The major product friction-welding machine is the No. one among the same products in China. The milling machine is at the fifth position. These are results of the technology improvement of the old enterprise. The level of the technology is advanced, and the product has a good market. Now, it is co-operating with Jilin University to develop new products.

4. The new enterprise is a solely state-owned company after restructuring. The new enterprise is studying how to transform the company into stock-holding one, so that it can reform the company’s structure to
realize diversified investors.

5. The employment of the new enterprise is adopting the new approach that workers shall be hired through applications for jobs at each level and competition for employment. The system of distribution is also different that the wages of the workers at the primary level judged by pieces, and the salary of the technicians is determined by the negotiation. Thus, the new enterprise aims to set up incentive and restraining mechanism according to the modern enterprise mechanism. Before the completion of the transforming into stock-holding company, the workers in the new corporation still remain state-owned enterprise staff and worker status, but with the development of the restructuring, the kind of status will inevitably change.

6. As a new independent legal entity, the new corporation does not need to pay the debts of the old enterprise in principle. (When time is proper, the old enterprise may apply for bankruptcy in accordance with the law). Nevertheless, in reality, the middle and small creditors always turned to the new corporation for the debts of the old enterprise. Confronted with such situation, MT Co. Ltd. adopted different approaches, i.e., different debts are treated differently. For the debts that have been due more than three years and other kinds of debts shall be dealt with differently. And the private creditors, the collective-owned enterprise creditors, and the state-owned enterprise creditors are treated in different ways. That is to say, MT Co. Ltd. first checks the accounts, then adopts appropriate approaches.

**Case 5: Changchun Electrical Furnace Plant**

In June 2000, the new enterprise completed restructuring by the approach of purchasing the profitable assets of the old enterprise. In this case, the value of both assets and liabilities of the old enterprise were more than RMB 1 billion. The new enterprise obtained the right of using the land, which owned by the old enterprise, through the investment by the government, and purchased the profitable assets (amounting to RMB 15 million) with the bank loan to settle part of the workers in the old enterprise. After restructuring, the new enterprise has got the increased assets by activating the land and improved the technology, which led to a quick increase of assets, and the financial situation is good.
A. The Situation before Restructuring

Changchun Electric Furnace Plant (EFP) produced electric furnaces for making steel. The annual output of steel-making furnaces was from 0.3 to 30 tons. EFP was set up in 1957, and in the period of its great prosperity, EFP’s products occupied 70% market share, with exports to 11 countries and regions. It began to decline after the overheated economic growth in 1993. The most difficult times were from 1997 to 1999, when workers could not get their wages for 14 months successively, with the liabilities-to-assets ratio up to 142%.

By March 31, 1999, the total value of output of EFP was RMB 1.02 million, with 959 workers at work and 86 lay-off workers (including the re-employed 55 workers). In this period, its assets structure was like this: floating assets were RMB 66.24 million, fixed assets RMB 49.38 million, intangible assets RMB 1.04 million, and the total assets were RMB 116.66 million. After deducting the accounts receivable, which were impossible to collect in effect, and other bad assets, the actual total assets were RMB 84.37 million. The debts structure was as follows: floating debts were RMB 83.98 million, the long-term debts RMB 17.35 million, plus the defaulted wages for staff and workers, social insurance funds, medical expenses, etc, the total debts amounted to RMB 128.32 million, and the liabilities-to-assets ratio was 152%. The primary creditor of EFP was the Industrial and Commercial Bank of China. The principle loan was RMB 29.55 million, and plus the interests, the debts were RMB 42.59 million in total, which was about 33% of the total debts of EFP incurred. The principle loan and interests owed to the other financial institutes were RMB 1 million, which was 0.8% of the total liabilities of EFP.

EFP had a good industrial basis. The major products were various electric controlling equipment, electric furnaces, electroslag furnaces, mineral furnaces, and refining furnaces wrapped with steel etc. The technology level was at the advanced position in China, and the products had considerable share in the market. Nevertheless, because of the problems left by history for a long time, such as the overstuffed organization, redundant personnel, imperfect business incentive mechanism, and heavy debts burden
etc., the enterprise born a heavy burden. Unable to circulate new funds, the enterprise fell into distress gradually, and became insolvent, and was on the verge of bankruptcy in the end.

B. The Process of the Restructuring

The process of debt restructuring of EFP is as follows:

- **Setting up a new enterprise.** In 1999, EFP started the restructuring. At the end of 1999, the high level competent authorities of EFP, i.e., the Changchun Mechanical and Electrical Equipment of State-owned Assets Management Co. Ltd., made adjustment in the leading parties of EFP. The Changchun Mechanical and Electrical Equipment of State Assets Management Co. Ltd. put in RMB 500,000, with RMB 12.5 million got by selling the right of using land, to establish Changchun Electric Furnace Limited Liabilities Corporation (hereby EF Co.). EF Co. started operating in February 2, 2000.

- **Trading assets.** EFP transferred its part of profitable assets to EF Co., including some buildings, equipment, and the stock, with the total value worth RMB 15 million. The Industrial and Commercial Bank of China loaned RMB 15 million to EF Co. to purchase those assets, with the purchased equipment and buildings as security for the loan.

- **Repaying the bank debts.** EFP paid the bank debts with the money of RMB 15 million received from EF Co. by selling the assets. The rate of repayment was 35%.

- **Settling the workers of the old enterprise.** There were originally 1,495 staff and workers in EFP. According to the agreement concerning settling the workers between EFP and EF Co. when purchasing the profitable assets from EFP, EF Co. agreed to accept 460 workers of EFP by the means of inviting applications for jobs and signing labor contracts. The rate of settlement is 31%. The rest of staff and workers of EFP, except that some were settled by lay-off, looking for jobs by themselves or retirement etc., remained in the old enterprise waiting for future chances of increased employment.

- **The situation of the old enterprise.** Since 1997, the old enterprise had been in semi-stagnation. In 1999, it completely stopped production, and now it is going to apply for bankruptcy by law.
C. The Situation of the New Enterprise after Restructuring

1. EF Co. utilized the right of using part of the land as investment, and co-operated with a real estate company to build buildings and run real estate business, and earned RMB 21 million income after paying taxes. EF Co. made use of the earnings to conduct technological transformation, adjust product structure, and co-operate with Italian Danieli Corporation to develop heavy-tonned and ultrahigh power furnaces, and produce 150 tonned refining furnaces wrapped with steel. The bank claim of EF Co. has reached to grade AA, so it can get loans from banks. At the same time EF Co. is trying to get the interest discount loan for technological transformation sponsored by the State Economy and Trade Commission to strengthen the product development.

2. By June 2000, the assets structure of EF Co. was as follows: floating assets were RMB 32.85 million, fixed assets RMB 25.12 million, intangible RMB 11.04 million, and the total assets were RMB 69.02 million. The value of assets increased three times than before in one year (the increased assets were mainly floating assets and intangible assets). In this period, the debt structure was: floating debts RMB 24.56 million, long-term debts RMB 15 million, and the debts in total were RMB 39.56 million, with the liabilities-to-assets ratio 57%. The balance point of profit and loss has declined from RMB 65 million to RMB 30 million. In July of the same year, the liabilities-to-assets ratio declined to 52.4%.

3. In 2000, the output value of EF Co. was more than RMB 20 million, the annual revenue RMB 18.16 million, which has increased 23%, and the profits were RMB 22,000. From January to June of 2001, the total industry output value was RMB 13.54 million. By July 2001, the total taxes turned over amounted to RMB 1.62 million. The financial situation and business of the new enterprise have a remarkable improvement contrasted with pre-restructuring EFP (See the chart below).
Table 2-3: The Contrasting Chart of the Financial Situation and Business Before and After Restructuring

<table>
<thead>
<tr>
<th></th>
<th>In 1999, the Electrical Furnace Plant</th>
<th>In June 2000, the Electrical Furnace Co.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities-to-Assets Ratio</td>
<td>137%</td>
<td>57%</td>
</tr>
<tr>
<td>Output Value</td>
<td>9.83 millions (RMB)</td>
<td>20 millions (RMB)</td>
</tr>
<tr>
<td>Sales Revenue</td>
<td>7.18 millions (RMB)</td>
<td>18.16 millions (RMB)</td>
</tr>
<tr>
<td>Profits</td>
<td>-5,809 (RMB)</td>
<td>26,000 (RMB)</td>
</tr>
</tbody>
</table>

4. The new corporation is co-operating with Italian Danieli Corporation to develop over-50-ton ultrahigh power furnaces. Now, the state has already granted the loan of RMB 31 million for it.

5. The new corporation has leased 22 machines of the old enterprise, and the annual rent is RMB 240,000.

6. The new corporation is still a solely state-owned enterprise at present. It is adjusting the inner management mechanism, and reforming the organization setup, employment system and wages system.

**Case 6: Changchun Sugar and Wine Group Corporation**

The special point in the Changchun Purchase Approach to Debt Restructuring of the Sugar and Wine Group Corporation of Changchun (SWG Co.) is that, the enterprise was a state-owned commercial enterprise but not an industrial enterprise. So it did not involve equipment, technological transformation, market for products, and other questions. The business difficulties of SWG Co. were resulted from adjustment of the state policy, the weakened consumer market, and the backward management. Nevertheless, there are still many features in common between the restructuring of the state-owned industrial enterprises and commercial enterprises from the point of view of the process of SWG Co. restructuring.

**A. The Situation of the Enterprise before Restructuring**

SWG Co. was set up in 1993, a state-owned commercial enterprise, which was based on Changchun Sugar and Wine Corporation. The major commodities of SWG Co. were sugar, tobacco goods, wine and tea. After the
reform and opening to the outside world, with the adjustment of the state economic policy, the rights of managing the tobacco goods and tea were taken away one after another. Especially, the right of managing tobacco goods was transferred to the Tobacco Corporation of Changchun in 1984, which had a deep impact on SWG Co. Prior to the tobacco management right taken away, the sale revenue of the tobacco goods was 51% of total sale revenue of SWG Co., and the sale profits were more than 60% of the total sale profits.

After the main management rights taken away, the management of sugar and wine fell into distress due to the change of the outside economic environment. Since 1991, China gradually opened the sugar and wine market. In 1993, the management of sugar and wine were completely regulated by the market. SWG Co. lost the monopoly status in the management of sugar and wine as it had had in the planned economy. Moreover, the sugar and wine market has been weakening in the recent ten years, and the competition in the market is fierce (especially the sugar and wine market), which led to the continuous decline in the sale profits of SWG Co.

There were 932 staff and workers at work in SWG Co. in June 2000 before restructuring, including 167 retired staff and workers. SWG Co. had nine subsidiary management companies, such as Sugar Subsidiary Company, Wine Management Company, No.1 Wholesale Market in Heishui Road, Beihuancang Storehouse Company, Food Subsidiary Company, and 11 functioning departments, such as Manager Office, Financial Department, Labor and Capital Department, etc. Among the management companies, the businesses of No.1 Wholesale Market in Heishui Road (mainly managing clothes and general merchandise), engaging in stall leasing, and Beihuancang Storehouse Company, were good, which supported the whole enterprise. And the other companies that mainly managed sugar and wine were all bad or in deficit.

By June 2000, the financial situation of SWG Co. was as follows:
1. The liabilities-to-assets ratio was 84.84%.
2. The total assets amounted to RMB129.10 million, in which the fixed assets was RMB 7.68 million, the net value RMB 3.21 million, the projects under construction worth RMB 53.67 million, the right of land
using worth RMB 15.65 million, the floating assets RMB 56.57 million, in which the accounts receivable were RMB 32.57 million (many had become bad debts, but were still booked in the entries), the value of the stock RMB 18.76 million, and the apportioned expenses RMB 2.6 million.

3. The total debts amounted to RMB 109.53 million, in which the debts owed to the Industrial and Commercial Bank of China was RMB 50.468 million, the interests due were RMB 11.676 million, in total RMB 62.146 million; the debts owed to Nong'an Credit Cooperative were RMB 2 million; the debts owed to the Sugar Corporation of China were RMB 12 million; the mortgage owed to business partners were RMB 9.62 million; fees for projects were RMB 6 million; the land taxes were RMB 1.6 million; wages owed to staff and workers were RMB 4 million.

4. The bank stopped loaning to SWG Co. and the enterprise was in great need of funds. Among the total debts, the debts owed to the Industrial and Commercial Bank of China were 57% of the total, and the debts owed to the other financial institutions were 1.8% of the total; the commercial debts payable were 16.4%, the taxes 1.4%, and wages owed to the workers 3.6% of the total debts. The RMB 6 million belonged to undue deposits of clients, which was 5.4% of the total debts.

The direct motivation of the restructuring was as follows:

1) Because SWG Co. owed debts due for a long time and was unable to pay off, many creditors demanded SWG Co. for debts and took No.1 Wholesale Market in Heishui Road and Beihuancang Storehouse Company as the main targets. As a result of non-ending suits the management of No.1 Wholesale Market in Heishui Road and Beihuancang Storehouse Company was affected to some extent, so that the going of the whole enterprise was in danger.

2) In recent years, our country made some economic policies to quicken the reform and development of the state-owned enterprises, especially, the decision concerning the state-owned enterprises reformation reported in the Fourth Plenary Session of the Fifteenth Central Committee, provided a macroscopic guidance and a good policy environment for the debt restructuring of SWG Co.

3) The practice and experience gained in some state-owned industrial
enterprises in Changchun on Purchase-Sale Restructuring since 1996 provided some good models worthy of reference for SWG Co.

4) Both the government and the creditors hoped to avoid entire bankruptcy of SWG Co., which would make nearly thousand of staff and workers jobless and the creditors get nothing in return.

B. The Process of the Restructuring

SWG Co. took the following steps in the restructuring:

- **Pre-restructuring procedures.** Before restructuring, SWG Co. did the following jobs:
  1. Gaining the support of the primary creditor, that is, Changchun Branch of the Industrial and Commercial Bank of China.
  2. Making a restructuring plan.
  3. Conducting the worker’s congress, and getting the support of the workers, putting it into the decision of the congress.
  5. Applying to the Department of the State-Owned Assets Management of Changchun for assets valuation.

- **Setting up a new enterprise.** In February 2001, Changchun State-Owned Assets Management Company of Commerce invested RMB 500,000 to set up Changchun Kelon Limited Liabilities Corporation (hereafter “Kelon”), engaging mainly in the business of Storehouse and stall lease, clothes and general merchandise. Kelon is an independent legal entity, and it has no any subordinating relations with SWG Co. The managing parties of the two are independent to each other and do not hold concurrent posts.

- **Obtaining loans from the bank.** From June 2000, with the co-ordination of Changchun government, SWG Co. negotiated with Changchun Branch of Industrial and Commercial Bank of China for half an year, and finally gained the support of the bank. The bank agreed to the debt restructuring, and promised to loan 12.83 million to purchase the profitable assets of SWG Co. (the purchased assets used as security).

- **Buying out the profitable assets.** In March 2001, Kelon purchased assets of No.1 Wholesale Market in Heishui Road and Beihuanccang Storehouse Company, subsidiaries of SWG Co., at the price of RMB
33.50 million. The Administration Bureau of the State-Owned Assets appointed its subordinated State-Owned Assets Valuation Firm to evaluate the value of the profitable assets. The sources of the funds paid for the purchase were from:

1. The five-year loan of RMB 12.83 million made by the Industrial and Commercial Bank of China;
2. The deposits of leasers of RMB 9.80 million for leasing the stalls of No.1 Wholesale Market in Heishui Road, which was transferred to Kelon together with the duty involved;
3. The wages owed to the workers and accumulation funds for housing of RMB 6 million, (which were owed by SWG Co. to the workers were transferred to Kelon, and the latter also assumed the related responsibility);
4. The rest funds were raised by Kelon in other ways.

The above assets were 26% of the total assets of SWG Co. in total.

- Leasing the assets of the old enterprise. Kelon and SWG Co. agreed that Kelon had the priority to rent the residual assets of the old enterprise, and the rent would be paid according to the lease contract.
- Paying the bank debts. Kelon paid SWG Co. RMB 12.83 million to purchase the profitable assets. And SWG Co. used the entire sum to pay the debts owed to the Industrial and Commercial Bank of China. The rate of repayment was about 21%. The rest debts (amounting to RMB49.32 million) owed to the Industrial and Commercial Bank of China were still borne by SWG Co.
- Settling the workers of the old enterprise. There were 765 workers at work in SWG Co. when restructuring. And Kelon settled 452 staff and workers after restructuring. The rate of settlement was 53%. At the same time Kelon accepted nearly 200 retired workers, and was responsible for related expenses. The workers, who were laid off when restructuring, including seeking for jobs by themselves, leaving their jobs voluntarily, remained employment relationship with SWG CO. would stay in SWG Co.
- Handling the old enterprise. SWG Co. continued its business after restructuring. The rest assets and debts were managed and undertaken by itself. The business income, including rent income, and the accounts receivable recovered, except for some used for the wages of the workers, were used to pay the owed debts, taxes and other debts.
C. The Effects of the Restructuring

Since Kelon was set up only for a short time, and SWG Co. just completed debt restructuring, the remarkable positive results are not obvious. Nevertheless, there are several points worth notice:

(1) As a new enterprise, the assets of Kelon are good. It has no debt burden left behind by the history. The new enterprise has a strong capacity for market competition and good development prospects.

(2) Most of staff and workers of the old enterprise have been settled in the new enterprise, which contributed to employment and social stability.

(3) The debtor of loans (amounting to RMB12.83 million) of the Industrial and Commercial Bank is Kelon, who has a strong debt repayment capacity, so the Industrial and Commercial Bank can take back the principal and interests on time.

3. Analyses and Evaluations

Verification of the Effects of “Purchase-Sale Restructuring”

There are five elements in evaluating the effects of the restructuring:

(1) The rescued profitable assets and the related intangible assets, (such as goodwill, customer network,) and the human resources, (such as operating team, special technologists);

(2) The repayment rate compared with bankruptcy liquidation, especially, the rate of repayment to the primary creditors, that is, to the bank, is remarkable;

(3) The remained employment, the meaning of which including economic aspects (saved costs for resettling and staff and workers relief), and social aspects (keeping the society stable);

(4) The absorbed investment, which refers to the external extension of the rescued assets and optimization of resources in the market;

(5) The increased taxes, which means the contribution of the restructuring to the increase of the social wealth.
As stated previously, the Purchase Sale Debt Restructuring Approach of Changchun has obtained “multi-wins” on the basis of the compromise between the debtor, local government and the primary creditors. Now let’s test and verify the four effects summarized previously according to the above six cases mentioned.

1. The Effects on Assets

The profitable assets have shaken off the yoke of debts of the old enterprise and have gained the necessary funds for keeping on operating. The new enterprise has a better goodwill and capacity for financing, so it can make the profitable assets operate regularly and make profits. The new enterprise can expand its business by means of transforming into stock-holding company, cooperation and merger, etc.

The key point of the Purchase Sale Restructuring Approach of Changchun is focused on the increasing value of the profitable assets. As shown in Table 2.4, after the new enterprise purchased the assets of the old enterprise by the means of the government putting in funds and the bank supplying loans, and operated for a period of time, the value of the assets all have a remarkable increase. According to the formula “debt ÷ net assets ×100% = liabilities-to-assets ratio”, under the condition that the liabilities are unchanged, the way of decrease the liabilities-to-assets ratio depends mainly on the increase of assets. However in reality, the principal debts always bring about interest debts and other debts (such as liquidated damages), and the market risks can also cause some unexpected debts (such as accidents liability and product liability). So, in addition to paying off the debts on time, it is an important approach to keep good financial situation and gain increased assets not at the price of increased debts.

In the above cases, the increased assets of the new corporation are from, firstly, the floating assets and the intangible assets formed in the operation of the enterprise; secondly, the new assets got by investment of the business income; thirdly, the new investment brought about by enterprise re-capitalization. Besides, an important reason is that while the new enterprise purchased the tangible assets of the old enterprise, the new
enterprise also gained some intangible assets of the old enterprise for free, such as the organization and management system of the enterprise, the system of technology support, the enterprise culture, the fame in the market, and the sale networks, etc., which contributed much to the value of the modern enterprise. It is obvious that these elements can neither create values nor be converted into cash for sale when an enterprise stops operating or in solvency. Therefore, rescuing the profitable assets of an enterprise in distress not only simply means making full use of the unused plants and equipment, but more importantly making the knowledge capital and relation capital, related with those profitable assets, keep functioning. Thus, we can compare the purchase of the profitable assets of an enterprise to the purchase of a well-trained living horse, that is to say, purchasing the profitable assets of an old enterprise may have the effect of “getting twice the result with half effort”, compared with investment in purchasing land and setting up a new factory. And it is necessary to invest a large sum of money in “software”, including the costs of perfecting enterprise system and developing the market, in order to be competitive in the market and gain the capacity to make profits.

From the point of the view of macro-economy, one more point to which we need pay attention is that the profitable assets, including hardware and software, are all social resources, but the supply of these resources is limited and even rare. To realize the economy increase, it is not only necessary to develop new resources, but also essential to protect and make full use of the existing resources. If we let the existing resources run off while developing the new resources, then the benefits of the increased amount gained by the development will be decreased or set off by the loss of the existing resources. For instance, the land, occupied by the enterprise in distress, is a sum of rare resources. If the increased need for the land did not take advantage of the land resources, then there would lead claims to the reserved cultivable lands.
Table 2-5  Assets of New Enterprises in the Cases of Purchase-Sale Restructuring Approach of Changchun

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Government Investment</td>
<td>11.9</td>
<td>9.76</td>
<td>3.33</td>
<td>10.5</td>
<td>17.55</td>
<td>0.5</td>
</tr>
<tr>
<td>Loans from Banks</td>
<td>9.56</td>
<td>24.28</td>
<td>21.58</td>
<td>17.69</td>
<td>15</td>
<td>12.83</td>
</tr>
<tr>
<td>Purchased Assets</td>
<td>9.56</td>
<td>42.56</td>
<td>21.58</td>
<td>17.69</td>
<td>22.65</td>
<td>33.5</td>
</tr>
<tr>
<td>Current Assets</td>
<td>53.17</td>
<td>58.33</td>
<td>39.46</td>
<td>33.92</td>
<td>61.15</td>
<td></td>
</tr>
<tr>
<td>Debt/Assets Ratio</td>
<td>56%</td>
<td>59%</td>
<td>86%</td>
<td>67%</td>
<td>52%</td>
<td></td>
</tr>
<tr>
<td>Investment in Others</td>
<td>12</td>
<td>24.75</td>
<td></td>
<td>0.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Transformation into Stock-Holding Co.</td>
<td>Completed</td>
<td>Under Consideration</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

In the above cases, we have seen in some cases that the existing capital has been successfully utilized. For example, Changchun Vehicle Lamps Corporation, on the basis of purchasing the assets RMB 20 million of the old enterprise with the investment of RMB 3 million from the government, made use of the technology and market resources of the old plant to attract the outside investment, and has formed the assets scale of RMB 1.2 billion. Changchun Printing Machine Corporation retained a group of special technologists with high quality, while purchasing the tangible assets of the Printing Machine Plant, which laid a foundation for future upgrading products and enlarging the assets scale. Changchun No.2 Machine Tool Corporation has utilized the land resources to exchange for funds and gained increased capital of RMB 1.2 billion, which enabled the advantage accumulated from former technology transformation to get rid of the financial difficulties, and has realized its real market position and made profits. And Changchun Electric Furnace Corporation took advantage of the income earned by activating the land assets to cooperate with foreign
enterprise to develop new products, which has laid a good foundation for the development of the enterprise.

The above cases show that since the new enterprise still bore a heavy bank debt after purchasing the profitable assets from the old enterprise, in a period, the sources of funds mainly depend on absorbing the outside investment and activating the land assets in addition to the sale income. If the new corporation can keep good financial situation and remarkable business achievement, then it may get loans from banks soon. For instance, Special Vehicle Corporation and Electric Furnace Cooperation have recently got loans from banks, which is a good case in point.

It needs to be pointed out that in the “Purchase Sale Restructuring Approach” of Changchun, the purchasers are all newly set up state-owned enterprises by the government solely, and the usual merging method of attracting outside purchasers is not adopted. The benefits of Changchun Approach are:

(1) Decreasing the cost of the negotiation;
(2) Avoiding the integrating cost after merger;
(3) Beneficial to settlement of the workers of the old enterprise;
(4) Leaving enough room for the future stock-holding transformation and pooling capital.

The disadvantages of this approach are the single source of depending upon the government, the investment sources are limited and the future reformation may incur some cost of negotiation. According to the introduction of the Commission of Economy and Trade of Changchun, in a recent case of restructuring, the new enterprise is a corporation with multi holders.

2. The Effects on Debts and Claims

The primary creditors, that is, the banks, got the new claim to the new enterprises. This claim is considered high quality assets. At the same time, the old enterprises paid part of the debts owed to the banks, so the same amount of bad debts have been deducted from the banks’ bad debts. The creditors can get a higher rate of
repayment in this way than by the way of bankruptcy liquidation.

There is a common point in the debts of SOEs, that is, there is always one primary bank creditor who held the most claims among the creditors. As shown from the Table 2-6 below, in the above-mentioned cases, the average proportion of the amount of the primary bank claims to the total debts is 63%.

Generally, the more claims the creditor holds to one enterprise, the more losses he will bear when the enterprise goes bankrupt, so he will benefit more from rescuing the enterprise. So when conditions are proper, the primary creditor is active in rescuing the enterprise. However, any one will have to consider the rate of input and output when rescuing an enterprise. When an enterprise is in distress, the benefit to the creditor is judged by decrease of losses he may get.

<table>
<thead>
<tr>
<th>Name Item</th>
<th>Special Vehicle Plant</th>
<th>Printing Machine Plant</th>
<th>Vehicle Lamp Plant</th>
<th>No.2 Machine Tool Plant</th>
<th>Electric Furnace Plant</th>
<th>Sugar and Wine Co.</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Debts of Enterprises</td>
<td>130</td>
<td>91.13</td>
<td>104.84</td>
<td>126.15</td>
<td>128.32</td>
<td>109.53</td>
<td>114.5</td>
</tr>
<tr>
<td>Amount of Primary Banks' Claims*</td>
<td>58.54</td>
<td>55.57</td>
<td>60.25</td>
<td>106.11</td>
<td>42.59</td>
<td>62.146</td>
<td>64.2</td>
</tr>
<tr>
<td>Proportion in Total Debts</td>
<td>62%</td>
<td>69%</td>
<td>57%</td>
<td>84%</td>
<td>33%</td>
<td>57%</td>
<td>60%</td>
</tr>
<tr>
<td>Paid Debts</td>
<td>9.56</td>
<td>24.28</td>
<td>21.58</td>
<td>20.69</td>
<td>15</td>
<td>12.83</td>
<td>17.32</td>
</tr>
<tr>
<td>Rate of Repayment</td>
<td>20%</td>
<td>43.6%</td>
<td>35.8%</td>
<td>19.5%</td>
<td>35%</td>
<td>21%</td>
<td>29%</td>
</tr>
<tr>
<td>Claims to the New Co.</td>
<td>9.56</td>
<td>24.28</td>
<td>21.58</td>
<td>17.69</td>
<td>15</td>
<td>12.83</td>
<td>16.82</td>
</tr>
</tbody>
</table>

*The primary bank creditor here mainly refers to the Industrial and Commercial Bank except that Special Vehicle Plant had two major bank creditors: the Industrial and Commercial Bank and the Construction Bank.

It is reported that “the total amount of the assets of the enterprises, who
entered into the bankrupt proceeding was RMB 37 billion in 1996, the total amount of the debts was RMB 540 billion, and the average liabilities-to-assets ratio was 148%. And most debts were loans owed to the state commercial banks. The repayment rate of those enterprises who had finished or entered into the bankrupt proceedings was 5%. To banks, these loans to such enterprises have become non-performing or bad debts.25 The reasons why the rate of repayment was so low are as follows:

1. The unavoidable losses of the assets in liquidation. In other words, there is a big difference between the evaluated value of the assets and the cash value of the assets.
2. A large amount of expenses used to settle the workers and a large sum of bankrupt expenses.
3. The priority of the laborer claim and taxes claim.
4. The difficulties in cashing the mortgaged fixed assets, expenses cashing the fixed assets as well as the deduction from the income of the land.26
5. The abnormal conducts of the enterprises as well as those of the insiders of the enterprises, (such as maliciously dodging debts, corruption and wastes, etc.)

In the above cases of Changchun, all the restructuring transactions followed a rule, that is, the bank loaned a certain sum of money but got double income. One income is the claim to the new enterprise, and the other is the payment for the debts by the old enterprise. On the one hand, the bank has the stable interest income and reliable security to the debts that the new enterprise owed to the bank. On the other hand, the old enterprise paid the debts owed to the bank, and the rate of repayment is higher than the rate by bankruptcy liquidation.

As we can see from Table 2-5, in the six cases, the primary bank creditor got repayment from the old enterprise, and the highest rate of repayment is 43.6%, and the lowest is nearly 20%, and the average rate has reached to 29%, which is higher by 24% than the average rate of repayment

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26 Most right of using the land of the state-owned enterprise is allocated. In accordance with the relevant stipulations, the revenue of the land shall be submitted to the local finance when trading the buildings on the land.
by bankruptcy liquidation. In other words, in the above six cases of debt restructuring, the banks have taken back nearly RMB 1 billion bad debts more than in bankruptcy liquidation in total.

3. The Effects on the Workers

The workers of the old enterprise have retained their employment. Moreover, the salary of the workers has generally increased after they enter the new enterprise.

The key to the rescuing enterprise is the profitable assets. To keep the profitable assets existing and developing is the basic prerequisite for protecting the creditor’s benefits and the workers’ employment. In order to protect the profitable assets, the creditor has to make some concessions, so do the workers. We can not demand the new enterprise to accept all the workers of the old enterprise. The new enterprise should take a reasonable settlement rate on the principle of optimizing the human resources and saving costs. Otherwise, once the new enterprise is pulled down by overstaff, all the workers will be out of work.

As we can see that during the process of Purchase-Sale Restructuring Approach of Changchun, both the government and the workers are rational. Firstly, the government did not force the new enterprise to take the workers of the old enterprise by assigning a certain quota. On the contrary, the government actively helped the old enterprise to settle the workers in different ways, (for instance, the case of No.2 Machine Tool Plant). Secondly, before restructuring, since the enterprise communicated and entered into an agreement with the workers through the workers’ congress, the workers generally could accept the settlement plan. As a result, there is no such a case in which the new enterprise was compelled to accept all the workers of the old enterprise.

Generally speaking, the rate of the new enterprise of accepting the workers of the old enterprise is determined by the following:

1. The necessary labor for operating the profitable assets;
2. The increased labor that the new enterprise can attract for the future development; and
(3) The conditions that on which the rest of the workers could be settled through other means.

Table 2-7: Settlement of the Workers in the “Purchase-Sale Restructuring” Approach Cases of Changchun

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Wanting Settlement</td>
<td>1200</td>
<td>1371</td>
<td>767</td>
<td>1207</td>
<td>1495</td>
<td>765</td>
<td>1134</td>
</tr>
<tr>
<td>Number of the Settled</td>
<td>821</td>
<td>960</td>
<td>378</td>
<td>700</td>
<td>460</td>
<td>452</td>
<td>629</td>
</tr>
<tr>
<td>Rate of Settlement</td>
<td>56%</td>
<td>70%</td>
<td>49%</td>
<td>58%</td>
<td>31%</td>
<td>59%</td>
<td>54%</td>
</tr>
</tbody>
</table>

Table 2-8  The Hive Down of Profitable Assets of the Old Enterprise in “Purchase-Sale Restructuring” Approach Cases of Changchun

<table>
<thead>
<tr>
<th>Item</th>
<th>Special Vehicle Plant</th>
<th>Printing Machine Plant</th>
<th>Vehicle Lamp Plant</th>
<th>No.2 Machine Tool Plant</th>
<th>Electric Furnace Plant</th>
<th>Sugar and Wine Co.</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Assets</td>
<td>66.34</td>
<td>78.27</td>
<td>91.84</td>
<td>84.22</td>
<td>84.37</td>
<td>129.1</td>
<td>74.96</td>
</tr>
<tr>
<td>Assets Hived off</td>
<td>9.56</td>
<td>42.56</td>
<td>21.58</td>
<td>17.98</td>
<td>15</td>
<td>33.5</td>
<td>23.36</td>
</tr>
<tr>
<td>Rate of Hived-off Assets</td>
<td>14%</td>
<td>54%</td>
<td>23%</td>
<td>21%</td>
<td>18%</td>
<td>26%</td>
<td>26%</td>
</tr>
</tbody>
</table>

Because the new enterprise only purchased part of the assets of the old enterprise (from 14% to 54%, with the average 26%, see Table 2-8), therefore, the new enterprise can only accept part of the workers of the old enterprise (from 31% to 70% with the average 54%, see Table 2-7). Anyway, by comparison, the rate of accepted staff and workers is twice more than the rate of the purchased assets.

4. The Effects on Society
The government has realized its aim of activating the state-owned assets in stock, keeping staff and workers employed and social stable with a small sum of money. And the government can get taxes revenue from the new enterprise.

As we can see in Table 2-5, the total amount of the government’s input of capital in the six enterprises to rescue the enterprise is RMB 19.73 million. And the rescued profitable assets amount to RMB 130.70 million, and 16,741 staff and workers are employed directly with the profitable assets. In the average, each input of RMB 10,000 can rescue the assets amounting to RMB 150,000, and settle 8.5 workers. Moreover, it can not be estimated that the increase of the value of assets and the progress of the technology, i.e., keeping the technological equipment and the specialists so as to lay a foundation for the progress of the technology.

| Table 2-9   Taxes Paid by New Companies in Changchun Debt Restructuring Cases |
|-------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Accumulated Taxes Paid | 0.37 | 6.16 | 0.98 | 1.62 | * | ** | 9.13 |

* Electric Furnace Co. was allowed to postpone its taxes in 2000, and will begin to pay taxes in 2001.

** Kelon has no business income currently.

After half of the workers in the old enterprise are settled in the new corporation, it relieved the pressure of the government and society to settle the employment and living of the rest staff and workers. This contributed much to the problem of settlement of the workers in the state-owned enterprises through various channels. Besides, the activation of the profitable assets of the old enterprise has also benefited the local economic flourishing and increase of the financial revenue. In the above cases, the taxes that the new enterprise paid annually are considerable (see Table 2-9). According to the tax system of China, any enterprise engaged in commodity transaction or services should pay circulation tax, and pay income tax when there are profits as well as other kinds of taxes. In fact, the taxes that new enterprise
has turned over annually are far more than the profits after the taxes.

**Comparison of the “Purchase-Sale Restructuring” Approach with Other Approaches of Debt Restructuring**

Up to now, the approaches of debt restructuring in China may be categorized into two types. One is based on debts, and the other on assets.

1. The Restructuring Mode based on Debts

The restructuring mode based on the debt focuses on the existing debts of the enterprise, and it tries to make the enterprise revive by decreasing or clearing up the debts. The main methods of this approach include administrative pay-off, putting in assets to write off the debts, debt transformation and bankruptcy liquidation.

*Administrative pay-off.* Administrative agencies of each level encouraged specialized banks and state-owned enterprises to concentrate on clearing up the inter-enterprises debts and the debts between the banks and the enterprises gradually according to the plans, in an organized way in a certain period. The most typical method was clearing up the triangle debts of China at the end of the 1980’s and in the early of the 1990’s. Although this method can quickly clear up a series of debts with a concentrated effort in a certain period of time, it may soften the restriction of the enterprise budge, which may contribute to the enterprise’s thoughts that “it is beneficial to default in debts, and it is a loss to pay debts” and enterprises tended to rely on the “finance to pay the bills”. As a result, a new large scale of debts was accumulated.

*Putting in funds to write off the debts.* The finance and banks utilized the state inventory capital to share the accumulated debts. For example, the state bank drew the reserves for non-performing or bad debts to write off the bad debts; and the government returned the taxes that the enterprise turned over to replenish the debt repayment funds. These methods played some role in resolving the problem of the enterprise debts to some extent, but very limited. Firstly, the amount of the bank reserves for non-performing and bad debts is small. It must be first used to deal with the bad debts incurred by enterprise.
bankruptcy. With many enterprises going bankrupt, the banks had no sufficient funds to actively discharge the enterprises from the debts. Secondly, the room of the financial in-put is very small, for the reason that most local finances were in the situation unable to make the ends meet. And many enterprises were in distress because of the losses and stopped production for a long time, so there were no tax returns. Moreover, too many financial in-put may cause the problem of “soft budget restriction”.

Debt transformation. Debt transformation includes “debts converted into stocks” and “debts converted into debts”. There are four specific methods in “debts converted into stocks”:

(1) The bank debts have been converted into stocks. The four financial assets management corporations have begun to do this job from 1999;

(2) The inter-enterprises debts have been transformed into stocks. This is a debt disposal method adopting market principles, and it has a full development potential. Now, cases of adopting this method to resolve the inter-enterprises debts are few.

(3) Transforming the debts of the inside staff and workers into stocks. Transforming the wages that enterprises owed to the workers and the compensation for giving up the status of the state-owned enterprise permanent staff into stocks, and the insider staff and workers hold stocks. It is a measure taken by the distressed enterprises to decrease the debts, when the enterprise is carrying out the transformation into stock-holding company.

(4) Transforming “allocation of funds into loans” into “loans into investment”. It is a special measure taken to deal with the special debts formed in special forms and special periods. There is a strict limit to adopt the method.\(^{27}\) In fact, “debts converted into debts” is the innovation of debts in Contract Law, i.e., the party that bore the debts is changed. For example,

\(^{27}\) “Allocation of funds transformed into loans” means that in the early 1980’s, to change the situation of the unified state revenue and expenditure and the enterprise enjoying the “big pot meals” of state finance in the planned economy, the state changed allocated funds for enterprises into loans from banks. As a result, some of the state-owned enterprises are established only with loan investment, but no input of capital funds. These enterprises bore heavy debts.

“Loans transformed into investment” means that in the middle of 1990, to resolve the debts of the enterprises without capital funds, the state changed the booked investment loan for the capital construction and all kinds of financial borrowing of the enterprise into state investment, so that it can decrease the debt ratio. By the end of 1996, the state changed the principal loan and interests, changing the allocated funds, amounting to RMB 242 billion of the 131 enterprises, into the state capital funds.
the debts formed when the enterprise was engaged in the community affairs are transformed into the financial debts; companies in the lower level bear the debts of the companies in the high level or vice versa.

The method of debts transformed into stocks is the most popular one currently. Its characteristics are that the transformation of the bad claim into stock rights leads to the increase of the total amount of the enterprise shares and the decrease of the value of each share. Thus, in fact, the original investors also made some sacrifices to realize the allocation of the risks of management failure and losses between investors and creditors. The advantages of this method are as follows:

- This method has changed the booked assets situation of the enterprise, which is good to improve the credit of the enterprise and enhance the enterprise financing capacity.
- This method has decreased the financial cost (the interests of loans), increased the profits in the enterprise benefit of the current period (or decrease the losses of the same period). Nevertheless, “debts converted into stocks” did not involve assets input (money or materials), so it is only a temporary measure. To have the substantial effect, it must be combined with other measures of improving the assets situation.

Bankruptcy liquidation. It is the most complete method to clear up the debts. However, bankruptcy liquidation is at the cost of the death of an enterprise legal entity, and it is not a method of rescuing enterprises. Bankruptcy liquidation also leads to the value of the assets running off and the increase of unemployment and other negative results. Certainly, it can be a kind of methods of rescuing enterprise by selling the assets of bankrupt enterprise in whole in the bankruptcy liquidation. Nevertheless, this method is always abused in China, which damaged the interests of banks. So it was defined as “false bankruptcy, real debt dodge” by No.10 document of the State Council in 1997. According to this document, only when the insolvent enterprise really stopped production and closed (legal entity deprived), the right of using land and property were sold in auction for cash, and the workers were settled, could it be called a qualified bankruptcy. If so, then it is impossible to rescue the enterprise in the pure meaning of assets, at least not now.
2. The Restructuring Mode based on Assets

The restructuring mode based on assets pays attention to the inventory assets of the enterprise. It tries to make the enterprise revive by the way of activating the profitable assets. The main methods of this mode are loans, increasing assets, merger, tax reduction and exemption or tax return.

*Loans and increasing assets* are the method of directly putting the increased funds into enterprises. This method may resolve the present funds shortage of enterprises and improve the producing situation and financial situation of the enterprise. However, the increase of the loans may lead to the increase of the debts. On the one hand, to an enterprise in distress, this method although can improve the producing situation of the enterprise for a short time, it is no use improving the financial situation. Moreover, it is difficult for a distressed enterprise to get loans from banks. On the other hand, though the increased funds may improve the financial situation of the enterprise, they can not decrease the debt burden of the enterprises. When an enterprise has the heavy burden of debts, investors seldom have motive to invest in such enterprise. The law shall not allow the enterprises, (such as the listed companies), to increase funds when losses occurred. So this method is usually adopted when the enterprise is at the early stage of the distress and the distress is not serious, and the prospect of the management is bright.

*Merger.* It refers to merger and acquisition. It is the property right transaction in which one enterprise bears the assets and debts of the other in general. In China, as a method to realize the state-owned enterprise of getting rid of the distress, merger means an enterprise, whose assets and management are in good condition, purchases the enterprise in distress in whole. This measure is regarded as an important way of rescuing the enterprise in distress under the direction of the government for a long time. The merger mainly takes such ways as bearing the debts, purchasing, absorbing shares and holding shares. In recent years, there appeared mergers like purchasing the “shell” to list in a stock exchange, lever purchasing and other mergers and acquisitions.

The merger method of bearing debts is the main method for the enterprise to get rid of the distress under the main conduct of the government.
70% of the total cases of mergers and acquisitions are taken in this way. The two parties in the merger are usually the state-owned enterprises under the same authority department. The adopted methods are either government allocation for funds without payment, or purchasing individual assets, that is, the purchaser got all assets and the management right of the targeted enterprise on the consideration of bearing all the debts. Among all these merging methods, the purchaser not only bore the booked debts of the targeted enterprise, but also assumed the hidden debts, such as, settling the workers and social security liabilities. In reality, the merger of good enterprise with the enterprise in distress always made the former bear the heavy debt burden of the latter. Although No.10 document of the State Council in 1997 provides that the enterprise with superiority purchased an enterprise that was at a loss for three successive years may be entitled to exemption of the interests of the original loans owed by the merged enterprise, and the principal may be repaid in five years (and may get one or two years extension if really difficult), it could not remarkably improve the financial situation and credit of the merged enterprise, and it also could not prevent other non-bank creditors from claiming payments of debts, and the assets of the enterprise were still fettered by the heavy debts. In fact, some enterprises not only were still in distress, but also involved the good enterprises in difficulty because of debts and lawsuits.

*Tax deduction and exemption and tax return* are in fact a kind of subsidy of the local governments by using the financial revenue of the current period (such as local taxes and the fees for land concession). In rescuing the distressed enterprises, these methods may be used as auxiliary methods to improve the quality of the assets of enterprises. However, the sum reduced, exempted and returned is limited, it is not enough to resolve the distress of the enterprises solely in this way.

3. The Characteristics of the Purchase-Sale Restructuring Approach of Changchun

Firstly, the Purchase-Sale Restructuring Approach differs from the

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debt-restructuring mode based on the debts. It does not pay attention to the existing enterprise debts, but to the existing assets of the enterprises. And it is different from the common repayment approach of debt restructuring, which keeps the profitable assets remain in the old enterprises, and tries to decrease the debts imposed on these assets. Practice proves that when an enterprise bears too many debts, the cost of decreasing the debts is higher and it is difficult to decrease the debts. The local governments and enterprises who adopted this restructuring approach tried every means to strive for the financial resources to reduce debts, but it is often in vain or getting half the result with twice the effort. In Changchun approach, the large amount of debts were set aside, and to rescue the productivity (profitable assets and human resources/labor) from the heavy debts by the way of purchasing.

Table 2-10  Comparison between Debts of Old SOEs and Profitable Assets in the Changchun “Purchase-Sale Restructuring” Cases

<table>
<thead>
<tr>
<th>Name</th>
<th>Special Vehicle Plant</th>
<th>Printing Machine Plant</th>
<th>Vehicle Lamp Plant</th>
<th>No.2 Machine Tool Plant</th>
<th>Electric Furnace Plant</th>
<th>Sugar and Wine Co.</th>
<th>Average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Liabilities</td>
<td>130.00</td>
<td>91.13</td>
<td>104.84</td>
<td>126.15</td>
<td>128.32</td>
<td>109.53</td>
<td>114.5</td>
</tr>
<tr>
<td>Total Assets</td>
<td>66.34</td>
<td>78.27</td>
<td>91.84</td>
<td>84.22</td>
<td>84.37</td>
<td>129.1</td>
<td>74.96</td>
</tr>
<tr>
<td>Liabilities-to-Assets Ratio</td>
<td>196%</td>
<td>116%</td>
<td>114%</td>
<td>150%</td>
<td>152%</td>
<td>85%</td>
<td>136%</td>
</tr>
<tr>
<td>Purchased Profitable assets</td>
<td>9.56</td>
<td>42.56</td>
<td>21.58</td>
<td>17.98</td>
<td>15</td>
<td>33.5</td>
<td>23.36</td>
</tr>
<tr>
<td>Purchased Assets to Total Liabilities</td>
<td>7%</td>
<td>47%</td>
<td>22%</td>
<td>17%</td>
<td>12%</td>
<td>31%</td>
<td>23%</td>
</tr>
</tbody>
</table>

Even though the government has some financial resources, it has to consider two different choices: transforming assets or transforming debts. When the existing debts are much more than the existing assets, the cost of the transforming assets obviously is less than the transformation of debts. According to the data in Table 2-10, if the approach of putting in funds to pay off the debts is adopted, in order to make the average debt ratio to profitable assets of the six enterprises decline to 60%, every enterprise had to
deduct the debts RMB 1 billion, and the cost is four times more than that of taking “Purchase-Sale Approach”.

In practice, if the method of transforming debts is adopted, it must be attempting nothing and accomplishing in the end nothing because of the shortage of the funds. And the outcome is, on the one hand, the debts can not be paid off, and on the other hand, the productivity and the value of the profitable assets would be wasted gradually due to the long-time leaving unused.

Secondly, compared with the other debt restructuring approaches based on the assets, the characteristics of the Purchase-Sale Approach of Changchun are that the hive down of the profitable assets from the debts of the enterprise has been realized and the profitable assets have also been hived off from the non-profitable assets. The debt burden of the assets has been lessened and the operating cost of the assets has been reduced (such as the expenses in maintaining the non-profitable assets). So the difference of the Purchase-Sale Restructuring Approach from the approaches of putting in funds and mergers is that the hive down of the profitable assets have powerful capacity to expand capitals. Sometimes, such assets may become the targets of the enterprise merger. Since these assets have no heavy debt burden and any related non-profitable assets, the efficiency of getting these assets merged is remarkably better than that of purchasing the old enterprise in whole.

In the past practice, there was an approach of “partial merger upon consideration”. There are some points in common between this approach and Changchun Approach. In this kind of merger, the purchaser only bears part of the debts, and gains part of the assets and the whole management right with the consideration of providing technology and management. The targeted corporation is still an independent legal entity, which has independent accounting and assumes sole responsibility for its profits and losses. However, the difference is that this kind of merger still binds the benefits of the merged assets with the other assets and debts of the targeted corporation. Thus, although the property right is hived off, the management body is still the original entity. Neither the merged assets can be made full use to gain management benefits without the fetter of the other assets, nor it
can solely get outside investment through transformation into stock-holding company, or other means. The hive down of profitable assets in Changchun Approach is completely independent. So it can not only independently be made full use to gain management benefits, but also can attract outside investment or co-operation.

Legal Analysis of the Purchase-Sale Restructuring Approach

1. Legality of Assets Transfer

In 1990’s, there was a prevailing practice of the enterprises on the verge of bankruptcy that dodged the debts by hive down. Specifically speaking, part of the assets, which are usually the profitable/profitable assets were picked out and hived off, and then were covered with “a legal entity coat” so as to cut off the relation with the enterprise debts. In many bankruptcy cases, the creditors found that many of the assets of the bankruptcy enterprises were transferred in this way before entering the bankruptcy proceedings. In November 1996, it was pointed out at the national liaison meeting of the presidents of financial claim management banks that “in some local enterprise bankruptcy, the methods of ‘hive down first, then bankruptcy’, ‘cutting off the new enterprise from the old’ were adopted, which led to false bankruptcy, but real dodge from debts, and caused the claim banks to suffer great losses.” For example, in a certain city of Middle South, “seven commercial wholesale enterprises adopted the practice of ‘cutting the new enterprise off from the old one’, and the new enterprises took away 46.8% of the assets, but only bore 8.3% of the debts, which caused the Industrial and Commercial Bank of China alone to have bad loans increased RMB 3.14 billion and dead loans RMB 1.17 billion.” In a county of Northeast, “there were 52 enterprises that applied for bankruptcy in the first half of the year of 1996, among which there were only 18 enterprises adopting merger, reconciliation and restructuring. 34 enterprises entered the bankruptcy proceedings, and made a concentrated effort to apply to the same court for bankruptcy in a week without the acknowledgement of the bank.”

29 The annex of information of the People’s Bank of China on printing and distributing the summary of the state liaison meeting of the presidents of financial credit management banks (Bank Issued {1996} No.413 ).
According to the Article 35 of Enterprise Bankruptcy Law of the People’s Republic of China (for Trial Implementation), promulgated in 1985, it is invalid to transfer assets without consideration, and only the liquidators have right to recover. But it is difficult for the creditors to apply this provision, because only the liquidators can exercise this right to recover, but the liquidators are usually appointed by the local government. If the hive down of the enterprise was authorized or with the tacit permission by the local government, then how could the creditors hope the liquidators to recover the assets which had been transferred to the new legal entity? Under this situation, the creditors had no way to protect their own interests.

In order to resolve this problem, the article 90 of the Contract Law of People’s Republic of China, which was promulgated in 1999, stipulates a new regulation, that is, one party hives off after the contract has been entered into, the hived off legal entity or other organizations enjoy a joint right and bear a joint liability of the contract. According to this regulation, although liquidators did not recover the hived-off assets, the creditors may have the right to sue or by other legal proceedings to demand the hived-off legal entity to bear the joint liability of the debts.

In Changchun Purchase-Sale Approach, the case is quite different. Firstly, before the old enterprise sold the assets, it disclosed the information to the bank and negotiated with the bank again until reaching an agreement with the bank. Secondly, the old enterprise got corresponding consideration when transferring the assets to the new enterprise and the price was evaluated by the legal qualified valuation institution and agreed by the creditor. Since the old enterprise transferred the assets with consideration, the total value of the assets did not decrease, so the interests of the creditors were not harmed. To put it in another way, it is a kind of sales contract. As long as the contract is not in violation against the provisions of the article 48 to the article 54 of the Contract Law concerning void or voidable contracts, then it is valid.

As to the transfer of the right of using land, one method in Changchun Approach is that the government assigned the right of using the land of the old enterprise to the new enterprise. The other method is the government offered the land using right to the new enterprise, but did not charge the cession fee temporarily. According to the current stipulations, these two kinds
of methods are permissible.\textsuperscript{30} The advantage of the first method is that the new enterprise need not pay for the land cost, but there are some restrictions when developing and managing the land in future. The advantage of the second is that the right of using the land can directly be exercised to develop and manage the land, though the owed cession fees become the debts in the account book of the enterprise. Thus, to adopt which method should be decided according to the requirements of using land and financial situation of the enterprise. It needs to be pointed out that, according to the current stipulations, when the state-owned enterprises go bankrupt, the original allocated right of using land is not counted as bankruptcy property, but taken back and disposed by the government (and the cession fees of the land are counted as financial revenue of the local government). If the enterprise is the experimental enterprise according to the rule of the State Council on the experimental enterprises upon optimizing the capital structure of the enterprise and enterprise bankruptcy, the right of using the land should be conveyed, and the conveyance fees should be used to settle the workers.\textsuperscript{31}

2. Protection to Primary Creditors

Different from the above-mentioned method of enterprise hive down, the Purchase-Sale Debt Restructuring Approach of Changchun provides enough opportunity for the primary creditors and other transaction parties to

\textsuperscript{30} Article 3 of the rule of \textit{Interim Provisions on Allocation of Land Using Right in State-Owned Enterprise Reform} issued by the State Land Administration Department on February 17, 1998 stipulates that “the right of using land involved in the state-owned enterprise reform can be disposed in different ways, such as conveying the land using right, leasing the land, the state subscribing with the right of using the land, and keeping allocated land based on different forms and situations”. Article 2 of Several Opinions on Strengthening the Administration of the Land Resources to Promote the Reform and Development of the State-Owned Enterprises, issued by the State Land Resources Department on November 25,1999 stipulates that “in state-owned enterprise reform, under the approval of the land administration bureau, different ways of disposing and managing the land resources may be adopted, according to the different requirements of the profession, enterprise types, and reform… (Ⅱ) The enterprises that are carrying out the state planned key projects of technological reform, the original allocated land can be used continually as the allocated land, and also can be used as investment (stocks) to put in land resources to the enterprises. As to the other enterprises, who are developing products and improving the technology with the matured technology, the original land can be disposed in the way of conveyance, and the revenue can be counted as the accounts payable and temporarily stay in enterprises to be used completely for the technology improvement, refer to the administration of the loans for technology improvement.”

\textsuperscript{31} See Article 58 of \textit{Land Administration Law} of the People’s Republic of China, and Article 6 of \textit{Interim Provisions on Administration of the Allocated Land Using Right in the State-Owned Enterprise Reform}, the State Land Administration Bureau (February 17\textsuperscript{30}, 1998).
negotiate face to face so that they can reach to an agreement based on the understanding. Obviously, in this type of restructuring, it is impossible to transfer the assets without the consent of the bank, because the first stage of these series of transactions is the bank loan to the new enterprise.

It is worth notice that the enterprise has been insolvent and may apply for bankruptcy when restructuring. So the protection to the primary creditors should be considered under this kind of circumstances. In other words, the liquidation test, which was created in the Bankruptcy Act of the USA in 1978, should be used to test the best interests of the creditor.\(^\text{32}\) In view of current enterprise bankruptcy practice of China, the legal protection to the creditors restrained by the urgent requirements to settle the workers. According to the rules of the State Council on the bankruptcy of the state-owned enterprises from 1994, all the assets of the enterprises must be used to realize the social-policy aims, that is, settling the workers and keeping the social stable. So the creditors can foresee that the repayment in the bankruptcy liquidation is very limited (usually the rate of repayment is 0 to 10\%). By contrast, the rate of repayment of the primary creditors in Purchase-Sale Approach of Changchun is much higher than that in liquidation. For instance, in the above mentioned six cases, the average rate of repayment is 26\%, and the highest is up to 44.6\%. Of course, the bank put in a certain amount of funds to attain this object. But it is an irrefutable fact that the bank gained some good assets, and wrote off some bad debts, when putting in funds. The reason why there are good assets formed is that the debtor of the funds, that is, the new enterprise, has good assets and management prospect. Moreover, the bank can raise mortgage on the purchased profitable assets, such as fixed assets and the purchased right of using the land put in by the government. If the new corporation gains incremental investment from the market, the claim interest of the bank is more guaranteed.

As Article 46 of the General Rules of Loan, which was enacted by the People’s Bank of China in June 1996, stipulates that “the lender has the right to take part in the debt restructuring of the enterprise in merger, bankruptcy,

\(^{32}\)Article 1129(a)(7), Chapter 11 of the US Code. As John C. Anderson pointed out that “the test of the creditors’ best interests is liquidation test, that is, the repayment that the creditor can gain according to the restructuring project should be more than that he can get in liquidation.” (John C. Anderson, Chapter 11 Restructurings, 1993 edition, p. 1-20 )
and transformation into stock-holding system and ask the borrower to fulfill the repayment of the principal debts and interests.” In the debt restructuring, the enterprise, as the borrower in the loan, has responsibility to respect the legal rights of the lender. When an enterprise owes debts to several financial institutions, it shall bear the same liability to all lenders. And only when all the lenders’ rights have been respected have the liabilities of the enterprise been fulfilled. Specifically speaking, in the purchase-sale debt restructuring, the old enterprise should invite all the lenders to take part in the negotiation and inform them of the relevant affairs. As to whether each lender likes to loan to the new enterprise and get corresponding amount of repayment from the old enterprise and the amount of the new loan supplied by each lender, it is all up to the parties to be decided in the negotiation. If the borrower breaches its duty in restructuring, he will be punished by withholding the loans according to Article 70, section 2 of the General Rules of Loan. Nevertheless, this punishment is inapplicable to the third party, i.e., the new corporation who purchased the assets.

3. Fairness to Middle and Small Creditors

If anyone doubts about the Purchase-Sale Debt Restructuring Approach of Changchun, the fair treatment to the middle and small creditors may be a focus. The middle and small creditors are usually the commercial creditors, such as the raw material suppliers, the construction businessmen etc. Indeed, there are no positions for the middle and small creditors in the restructuring transactions as shown in Table 2-1 in the Purchase-Sale Debt Restructuring Approach of Changchun. From the result of the transactions, there is no payment made to them. Moreover, with the decrease of the assets of the old enterprise, the opportunity for them to make a claim in civil execution proceedings is small. That is why some people blamed this restructuring approach for sacrificing the interests of the middle and small creditors.

Actually, we can not draw such a simple conclusion. We need to

33 Article 70, Section 2 of the General Rules of Loan stipulates that “the borrower violates any other provisions in Chapter 9 of this general rule, which leads to the failure to repay the debts, the lender may stop loans and take back the original loans ahead of time. The borrower and the person in charge or other individual who causes the losses of the assets should bear the liability of paying all the compensation or part of them. Prior to the fulfillment of the liability, any other lender shall not loan to him.”
First, of the transferred assets have already been mortgaged to the major creditors, the middle and small creditors have no opportunity to recover them. Even in the bankruptcy proceedings, the security creditors have the priority over the repayment with the mortgaged assets. It is beyond reproach that if the security creditor agrees his debtor to transfer the mortgaged assets to the third person, and get paid in the transferring transaction. According to Article 49 of the Security Law of People’s Republic of China, after the mortgagor informs the mortgagee, he can transfer the mortgage, the money that gained from the transfer should be paid for the debts of the mortgagor first. In practice, the main assets of the many debtors have become the mortgage of the primary creditors. The remainder that can be recovered by the middle and small creditors, without security, is usually few.

Of course, according to the stipulation of the law, the non-security creditors can recover the exceeded part that the value of the mortgage is more than the debt amount. However, it is a question to determine the existing of this excess. On the one hand, in each restructuring case, the bank debts had not been paid off. On the other hand, the going-concern value of the special production line of the industrial enterprise will be much devaluated in the auction in the market or in the division sale, so it is very difficult to prove the fact that the primary creditors gain illegal interests.

Second, if there is no mortgage on the main assets, and the insolvent enterprise has not entered into the bankruptcy proceedings, then the rule of the game is individual repayment, which means that the law encourages the practice that the swift-footed arrive first. In China, at present, it is a common phenomenon that it is difficult to sell the production line of the distressed enterprise in division. Because it may result in much value wasted. However, neither the middle and small creditors nor the court can easily find a purchaser who is willing to purchase the assets in whole. The transaction cost is considerable. That is why the middle and small creditors can not get paid with these assets before the large creditor gets payment. In this case, if the primary creditors are prohibited from rescuing these assets as the going-concern entity, while the middle and small creditors can not give any help, then the fate of the enterprise in distress is bankruptcy and close-down.
This result has no good to anyone. In the current bankruptcy proceedings for state-owned enterprises, the opportunity of getting the payment for the common creditors, (middle and small creditors usually belong to this type), is small. So, from the view of substantial justice, in the restructuring, it is more reasonable to carry out the rule of “all participants getting benefit” (i.e. who that takes out money to save the enterprise shall benefit from it) than the situation in which “everyone waits for a free lift”, (which leads to the fact that no one gets the lift).

According to the current Enterprise Bankruptcy Law, the individual repayment for the due debts before the court accepts the case is not restricted by the bankruptcy proceedings. So if there is no legal revocable reason, other creditors can not revoke the individual repayment in the later bankruptcy proceeding. Of course, in theory, the middle and small creditors may apply for bankruptcy to stop the individual repayment that the enterprise pays to the primary creditors before the transfer of the assets. Nevertheless, there are many restrictions for the creditor to apply the debtor bankruptcy in the current bankruptcy practice of China. It should be paid more attention to the proceeding obstacles that the court set when it accepts the application of a case. For example, in some areas, the court requires submitting the settlement plan of the workers when applying for the state-owned enterprise bankruptcy. Obviously, it is difficult for the creditors to do so. The other restriction is the market relation. At present, Chinese market is the buyer’s market, the customer resources are the living conditions for enterprises. The supplier always worries the fact that his voluntary application for the bankruptcy of his primary debtor will make him lose many clients, because the image of “cold-bloodness” may frighten the clients away.

Nevertheless, as we can not say that the interests of the middle and small creditors can be ignored just as we can not agree with the law that the weak are the pray of the strong. Justice and balance are always the basic rules of

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34 Nevertheless, the draftsmen of the new bankruptcy law of China advocated restrictions on the individual repayment before bankruptcy. There are such stipulations as: in the six months before the court accepts the bankruptcy case, though he debtor knows that he can not repay the debts, still pays to some individual creditor so as to damage the interests of the other creditors, the administrator has right to apply the court to revoke the payment.” If this stipulation had been adopted, this debt restructuring of individual repayment to the primary creditor will be challenged by the application of bankruptcy in six months.
the commercial society. In the debt restructuring practice of Changchun, the middle and small creditors let their voice be heard by some means. For example, in some cases, the new corporation is troubled continuously by the middle and small creditors, who require it to bear the debts of the old enterprise. The remedy that the new corporation provided to them is to keep a long-term contractual relation and give some preferential treatment. Some of them accepted this deal. In fact, they are not contented with such deal, but they understand that they have no choice but accept the sad reality under the current legal system.

Third, with a further analysis, we can find that the claims of the middle and small creditors can be categorized into two types:

(1) The claims that need to be paid with the bankruptcy assets in bankruptcy proceeding are as follows:

- Unsecured claims (including non-security assets, no guarantors);
- Secured claims but the secured assets are not enough to pay off the debts.
- The recourse right of the joint debtor of the old enterprise because it substituted for paying off the debts. These claims are expected to be paid off with the bankruptcy assets of the old enterprise. And it is in the last order to be paid in the bankruptcy distribution, so the decrease of the old enterprise assets means the damage of their payment interests.

(2) The claims that need not be paid with the old enterprise assets in the bankruptcy proceedings. There are two types:

- The claims secured by adequate property (such as mortgage, lien);
- The claims that the guarantor has adequate capacity to pay off the debts. The interests of this kind of creditors will not be influenced by the floating of the assets in the debt restructuring.

Fourth, generally speaking, in the assets transaction practice of the enterprise debt restructuring, there may appear following conducts:

a) The old enterprise individually pays the primary creditors and the workers with the money gained in transferring the profitable assets.\(^3\) Although it is individual repayment, and it does harm to the other

\(^3\) The individual repayment to the workers and staff included wages payable, welfare funds,
creditors, it is not illegal according to the current law in China.

b) The old enterprise transfers the assets or leased the assets, but the opposing party has not paid the consideration or rent yet. It actually may be regarded as free use without charge. But since there is a payment liability, after the old enterprise goes bankrupt, the liquidators may recourse the owed funds from the transferee and the leaseholder.

c) The old enterprise uses part of the machines and equipment as investment in the new enterprise. The right of the investment still belongs to the old enterprise, and it is counted as the bankruptcy assets when the old enterprise goes bankrupt.

d) Part of the assets of the old enterprise is allocated to other enterprises without payment. In this situation, the creditor may claim legal remedy. Any free appropriation of the enterprise assets is restricted by Article 35 of the Enterprise Bankruptcy Law. Moreover, if the practice of hive down is adopted, it shall be subject to Article 90 of Contract Law. Therefore, except for the first situation, the interests of the creditors can be protected by the law.

Fifth, in the cases of Purchase-Sale Debt Restructuring Approach of Changchun, the method of “three parties negotiating and the government assisting” was adopted. During the negotiation, the parties did not inform or disclose to the middle and small creditors the relevant affairs about the debt restructuring. Since the transfer of the assets gained the permission of the workers’ congress, the rights of the workers are considered and protected fully in the restructuring. In the current bankruptcy practice, the government and the court took priority over the workers, while the middle and small creditors had no chance to express their objection and improve their positions in the bankruptcy distribution. This situation is reflected in the interest order in the debt restructuring out of court. However, different from the bankruptcy proceedings, in the restructuring out of court, the claim right of the creditors, who did not take part in the negotiation, would not be wiped out. So in the above-mentioned cases of Changchun, it is understandable that some creditors demanded the new enterprise to pay the debts of the old enterprise even sued the new enterprise for the debts. We can say that the current method can not adequately protect the middle and small creditors’ right to be

housing turnover funds, special funds payable, etc.
informed and right to object in restructuring, and it is not fair enough and also brings about the cost of coping with the aftermath to the new enterprise.

Sixth, in some cases of Purchase-Sale Restructuring Approach of Changchun, the new enterprise provided new business opportunity for the middle and small creditors of the old enterprise, who are mainly suppliers of the raw materials and accessories, such as continuously purchasing raw materials, keeping cooperation in products, which made them get benefits indirectly from the enterprise debt restructuring. In some cases, the new enterprise also gave preferential treatment to these “old clients” in price and other transaction conditions. It is reported that some creditors showed understanding and positive co-operation, because if the old enterprise went bankrupt without restructuring, the middle and small creditors could hardly get anything after settling the workers, paying the priority creditors and turning over taxes. Moreover, the bankruptcy of the old enterprise means the decrease of their business clients and stopped co-operation. By contrast, the restructuring may bring more benefits than the liquidation in the bankruptcy proceedings.

With the above analysis, in the enterprise debt restructuring out of court, the enterprise in distress would bear the transaction costs of individual negotiation with many creditors, because of the shortage of the consistent and mandatory proceeding system. If sacrificing the efficiency to realize the proceeding justice, the final result is that every party loses. However, the short-term efficiency at the price of justice will damage the long-term efficiency in the market. The interests of the middle and small creditors and the interests of the new enterprise, the old enterprise, the bank creditors, the workers and the government are not balanced in fact. The former is basically in a disadvantageous position, such as detained payment, inadequate information and lack of opportunity in participation in the negotiation. Moreover, it is important that the transfer of the assets in restructuring was based on the latter’s interests, and the possibility of damages to the former’s interests was ignored. This situation will lead the middle and small creditors to decrease the trust in the current legal system, which may cause them to seek other kinds of protective measures, such as lump-sum payment transaction or endless claims for debts or lawsuits. As a result, it will increase the cost of the market transaction. And it may also make the suppliers of
marketable products unwilling to sell on credit to the state-owned enterprises that owed much to banks.

4. Consideration about Interests of workers

In China, the problem of settling the workers is one of important concerns of the current policy makers. It is important to consider the interests of the workers not only in the bankruptcy proceeding but also in the debt restructuring out of court. In the case of restructuring out of court, it must be more careful to settle the problems concerning staff and workers, because after the court makes the decision of distribution, it is mandatory to all the interested parties. However, the disposal agreement made in the debt restructuring is not mandatory to the workers. And the workers in state-owned enterprises normally thought that they were the owners of these assets. Obviously, the assets transfer agreement were discussed and passed by the workers’ congress in the cases of Purchase-Sale Restructuring Approach of Changchun, and the majority staff and workers were employed by the new enterprise. It is understandable that the workers concerned much about employment. The transfer of the profitable assets brought about new employment opportunity in this assets transaction, and the workers became the first beneficiaries. Moreover, keeping employed is closely related with social stability, so the local government is a beneficiary too.

Generally speaking, the workers employed by the new corporation could not automatically cut off their special labor relations with the state. Because of system of low wages and high welfare, named “iron bowl” in the planned economy, the depreciation of the labor was actually put in “the big pot” of the finance. Now, if the state wanted to break the “iron bowl” and take the “big pot meal” away, then the state had to pay the workers compensation for it. However, the finance has no capacity to bear this debts left behind by the history. The assets of the enterprise are the only guarantee. So if the enterprise is the solely state-owned enterprise, on the one hand, the workers can clearly distinguish the old historical debts with the state from the labor contract with the new enterprise; on the other hand, they would not abandon their status of the state-owned enterprise permanent staff easily just because they were hired by the new enterprise. So, if the state wants to get rid of the original labor relationship, it must pay compensation. When the
new corporation carries out transformation into stock-holding system, it is permissible to compensate the workers either in the approach of converting the existing assets prior to the transformation to compensate the workers then converting this part of assets into shares held by the workers, or in the approach of converting the state assets into shares, then using these shares to compensate the workers.\textsuperscript{36}

5. Proper Consideration about Market Environment

As to the market environment, people usually pay attention to the functions of the government. According to the views of some scholars, there are too much government participation in the Purchase-Sale Restructuring Approach of Changchun, so it is against the “principle of free contract”. This idea is too general. At first, we must realize that the government is the owner of the enterprise in distress. In the market economy, nobody will deny the right of the owner to take part in the restructuring process involving his property. Secondly, in the practice of Changchun, the local government is the main investor. It took out money to save the enterprise, at the same time it saved the creditors. It is legal according to the law of China. Thirdly, during the negotiating process, Changchun government respected the free contractual right of the parties, especially that of the primary creditors. Since the local branch of the state commercial bank is independent to the local government, and it is up to the bank to agree to the assets transaction. The interference of the local government in the transaction is little. Fourthly, when there is conflict of interests of the parties and multiple administrations, the coordination of the local special department can decrease much cost of the transaction and improve the efficiency of rescuing the enterprise. It is proved by the experience of the many countries, including China.\textsuperscript{37}

Another element that people pay attention to is the market environment. Good faith is an important principle in market transaction. The legal policy

\textsuperscript{36} It needs to be pointed out that, if the profitable assets were not separated from the debts, converting the assets into shares to compensate the workers means cheating the workers into abandoning their rights of claiming compensation with the bad assets. It is unfair. Because when insolvent, the enterprise’s net assets are zero or negative.

\textsuperscript{37} The government of Changchun set up an Enterprise Reform and Economic Structure Restructuring Office, led by a vice-mayor, to provide remarkable policy guidance and coordination in the debt restructuring.

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of current contract law and bankruptcy law restraining default conducts, but it does not prohibit flexible methods to resolve the dead and bad debts by negotiation. As advocated by economists, every operating body should bear the liability by itself, and it should not externalize the costs and the risks, that is, transferring the costs and risks to other market participants. Nevertheless, in reality, this saying is not absolutely right. We have good reasons to believe that the healthy economy indeed needs a social mechanism to resolve the unexpected market risks. It is good to encourage parties to resolve the problems caused by the enterprise bankruptcy via negotiation. The effective running of this mechanism depends on a series of legal regulations, and it is critical to give fair opportunity to participate and increase transparency. Practice has proved that the common interests between the parties are only the objective basis for agreement. Without good faith, it is impossible to reach unanimous restructuring agreement through negotiation. We can say that the trust between the bank and enterprise and the trust between the managers and the workers are the key to the success of the restructuring.

In the view of market credit, giving the middle and small creditors an opportunity to take part in restructuring is not only good to the balance of the interests between the parties, but also good to the credit of the restructuring enterprise. After all, the successive relationship of the assets between the old enterprise and the new is well known. The method of ignoring the middle and small creditors, (called operating in a black box), negotiation among the minority and damaging the interests of the majority, will make the enterprise fall into the discredit of harming others to benefit oneself. So, the debt restructuring of the enterprise should seek the interest coordination in the greatest degree. And the government department, who guides and helps the enterprise to restructure, should try to remain neutral in protecting the interests of all the parties. Moreover, protecting the middle and small creditors to a great extent means safeguarding the credit of the local market, and promoting investment and business.
III. International Comparison on Approaches of Debt Restructuring of Distressed Enterprises

Introduction

Corporate rescue or rehabilitation may occur through two types of procedures, which often exist side-by-side: (1) formal corporate restructuring regimes, often subject to judicial control; and (2) informal out-of-court rescue procedures. Out-of-court restructuring negotiations are more likely to prove successful when taking place in the shadow of a transparent, effective formal insolvency procedure. It is therefore a positive development in China that simultaneously with the SETC’s search for effective methods for the out-of-court restructuring of SOEs, the Chinese government is also drafting a new bankruptcy law (the “New Chinese Bankruptcy Law”) that includes a new formal corporate rescue mechanism – although at present it is uncertain to what extent the New Chinese Bankruptcy Law will apply to SOEs. Although an analysis of the corporate rehabilitation procedures in the new law is outside the scope of this project, it is important to note that any informal out-of-court initiatives for the restructuring of SOEs promulgated by the SETC would benefit from extending the New Chinese Bankruptcy Law to all SOEs.

Before turning to a discussion of the restructuring of SOEs, it is first necessary to review the central features of SOEs and the overall context of their predicament. These factors, when taken together, demonstrate the need for creative, alternative solutions. Firstly, many SOEs have far too much debt that they have been carrying on their books for many years. Second, SOEs’ financial difficulties are caused by a variety of factors – ineffective management; the use of out-dated obsolete technology; the failure and, in some cases, the inability to operate under free market conditions; and a very
high social burden, which results from the need to retain far more employees than are appropriate for the efficient running of an enterprise and the difficulty in making employees redundant. Third, there are insufficient state resources available for relieving SOEs from their high levels of debt distress – similarly the state banks are also not in a position to advance substantial funds to alleviate SOE problems. Fourth, since the markets for capital and property transactions are still in their infancy, important legal, professional, and financial infrastructures have not yet matured to the stage where they are effective in preventing SOEs from accumulating dramatically high levels of debt. And fifth, attention must be paid to China’s on-going transformation from a centrally-planned economy into something closer to a market system. A crucial part of this transformation involves the restructuring of the financial system, especially with the additional pressures of China’s upcoming accession to the WTO. Although the restructuring of China’s banks lies outside the scope of this project, it is inter-related with the out-of-court rescue of SOEs. The recent experience of many other Asian jurisdictions (described in greater detail below) demonstrates that through the restructuring of the financial sector it is possible to restructure a bank’s corporate debtors. In addition, attention must be paid to the origins of the bad debts of many State-Owned Banks. In some cases the SOE debts owed to the banks are the result of a previous existing administrative system of allocation, rather than of loans willingly made with the expectation of being paid back; in other words, book entries have been converted to “debts”. In many cases, if these debts are treated as non-performing the banks will be considered insolvent. Thus, there are great incentives for the banks to assist with the “rescue” of SOEs.

As noted by the SETC, to address these problems it is helpful to study the successful (as well as the unsuccessful) experiences from abroad, with a view to considering whether some of the foreign developments might be suitable for addressing the problems involving the financial distress of SOEs in China.

The objectives of this project are to: (1) investigate and analyze the current situation and the symptoms of enterprise distress in China; (2) review the successful and unsuccessful practices of treating the debt-related distress of SOEs in China; (3) study relevant methods, institutions and cases used in
economies abroad; and (4) advise on related options, methods, policies, and institutions for the present and future rehabilitation of distressed enterprises.

To meet these objectives, Professor Wang Weiguo took responsibility for the investigation and research in China and Professor Charles Booth for the international comparative research. As part of the international comparative dimension of this project, Professor Booth has established a panel of foreign insolvency and corporate restructuring experts (the “Insolvency Experts Panel”). Panel members were drawn from a variety of jurisdictions to ensure that there would be a variety of perspectives on corporate rescue. Panel members have been drawn from the following three types of jurisdictions:

1. jurisdictions that have moved, or are in the process of moving, from centrally planned to market economies;
2. jurisdictions that have developed out-of-court restructuring mechanisms as a response to the Asian Financial Crisis; and
3. Western jurisdictions that have a long-standing record of achieving success in out-of-court restructuring.

The members of the Insolvency Experts Panel include 29 persons from 14 jurisdictions: Geoffrey Sutherland (Australia), Dr. Alexander Klauser (Austria), Patrick McCarthy QC (Canada), Patrick Shea (Canada), Prof. Christoph Paulus (Germany), Joe Bannister (Hong Kong), Campbell Korff (Hong Kong), Alan Tang (Hong Kong), Steven Briscoe (Hong Kong), Rupert Purser (Hong Kong), Mark Sterling (Hong Kong), Sumant Batra (India), Prof. Shinjiro Takagi (Japan), Judge Hyungdu Kim (South Korea), Prof. Soogeun Oh (South Korea), Bharat Raj Upreti (Nepal), Bertie Mehigan (Singapore), Hon. Justice Ralph Zulman (South Africa), Angela Itzikowitz (South Africa), George Kelakos (Thailand), Terry Bond (United Kingdom), David Leibowitz (United States), Prof. Charles Mooney (United States), Prof. Jay L. Westbrook (United States), Alan Kornberg (United States), Prof. Steven Schwarcz (United States), Prof. Mark Scarberry (United States), Prof. Bruce Markell (United States), George Kelakos (United States).

The members of the Insolvency Experts Panel each have made a submission as part of this project, which are attached to this Report. The discussion below draws from these submissions.

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1. Reviewing of Practices of Treating the Debt-related Distress of SOEs in China

There are certain elements of the restructuring model in China that differentiate China from many of the market economies from which Panel members have submitted comments. First of all, throughout the restructuring process the government sits at many seats at the negotiating table – as the owner of the SOE, as the administrative authority responsible for the SOE, as the owner of the state bank, etc. Although some of these governmental entities are semi-autonomous of the others, and although historically State-Owned Banks have borne the brunt of the debt burden in the rescue of SOEs, it nevertheless complicates the process when the government is involved in so many capacities. In such a situation, reorganizations achieve different objectives than in more market-oriented economies. Rather than individual stakeholders trying to maximize value for themselves, in China it is more of a matter of reallocating state resources.

Second, in China, unlike in more market-based economies, the debtors in effect cannot be made bankrupt. In most Western countries, if the rescue negotiations fail, the debtor company almost inevitably will end up in formal bankruptcy or reorganization proceedings. In China, however, if the out-of-court negotiations collapse, the debtor SOE rarely, if ever, will go into formal bankruptcy or reorganization proceedings. This dramatically changes the nature and effect of the negotiations, for as noted above, the out-of-court rescue negotiations operate in the shadow of the law; and if the SOE cannot be made bankrupt, that, in turn, can in effect make the SOE judgment proof and put the SOE in a much stronger bargaining position.

Third, in those rare cases where an SOE is made bankrupt, further problems are caused by the lack of experienced, independent, commercially-minded judges. A short-term goal needs to be to develop an independent judiciary that is well-trained in insolvency law.

Fourth, there are few well-trained insolvency professionals – either
lawyers or accountants – in China, who are able to advise SOEs and creditors as to insolvency related matters in either workouts or formal insolvencies or to handle matters such as the valuation of assets.

Fifth, aspects of the Changchun approach could arguably be attacked as fraudulent preferences, or even fraudulent conveyances were formal bankruptcy proceedings to be commenced. But, as noted above, since such proceedings are unlikely to be commenced, there is no other law that is applicable for attacking such transactions.

In essence, the Changchun model involves what is called in the West a “hive down” in which the profitable and higher quality assets are transferred to a new entity. In the Chinese version, the primary bank lender makes a loan to the new company that is equivalent to the value of these assets. The new entity uses these funds to purchase the assets from the old SOE, and the old SOE, in turn, uses the funds to repay the primary bank lender. At one level, the money has just gone around in a circle; but at closer inspection much more has happened. The primary bank lender has made a new loan to a new entity that will be secured by high quality assets. The loan that the old SOE repays to the bank is the old loan. Thus, the primary bank lender receives repayment of its old loan when other creditors appear to get paid nothing.

Hive downs are not uncommon the West, but there are several important differences between the Western procedures and the Changchun approach:

- In the West, when a hive down is done, the new money that comes into the new entity usually is in the form of shareholders’ capital contributions, rather than a loan from the old entity’s primary lender.
- The old entity usually goes into bankruptcy, so any of the new money that the old entity receives would be distributed to creditors of the old entity pro-rata, rather than being used to repay the old entity’s primary lender.
- It is usually the case that much of the new money going into the new entity would remain in the new entity as working capital rather than all being passed back to the old entity. Also, unlike in the Changchun model, there would be no relation between the level of the working
capital raised by the new entity and the value of the assets transferred to the new entity by the old entity.

Comments of Experts

Members of the Insolvency Experts Panel were asked to comment on the paper by Professor Wang, “Changchun Approach: A New Scheme for Debt Restructuring in China,” with a view towards assessing the out-of-court restructuring approaches in Changchun that he describes.

Many members of the Insolvency Experts Panel have noted that the Changchun model has achieved some success. Among the points raised by the experts are the following:
1. Profitable assets are freed from the burden of the old debts, thereby freeing up the new firm to better utilize the assets; and
2. Many workers are able to retain their employment, by switching employment from the old to the new firm.

However, the experts’ submissions demonstrate many concerns about the Changchun Approach, especially in regard to its underlying fairness. Many of the submissions note the perceived unfairness in the process to creditors other than the major bank, especially the smaller creditors and workers who lose their jobs. A common theme of the Experts is that China should consider whether the Chinese situation is different enough from that in other jurisdictions to justify the differential treatment among creditors that lies at the heart of the Changchun Approach. They suggest that China should consider whether the economic benefits under the Changchun Approach outweigh the costs that they are likely to result from the continued application of the Approach.

There was consensus among the Experts that if general creditors and junior bank creditors realize that they are likely to get squeezed out in the reorganization of an SOE, they will consider whether they should continue to lend or provide services to the SOE. If they continue, it is likely that they will do so on terms that offset their increased risk – terms that are likely to include higher interest rates, the provision of services only when paid in advance, or the requirement of extra security.
The submission made by US Expert Professor Bruce Markell notes that many of the problems under the Changchun Approach also existed under a frequently used restructuring approach in the United States in the late 19th and early 20th century for railroads called the “equity receivership”. He points out that the equity receivership process – in which the shareholders in a railroad teamed up with the bondholders to transfer the assets of the old railroad to a new entity to the exclusion of the unsecured creditors – looks very similar to the Changchun Approach. He also cites several principles developed in the United States to thwart efforts by secured creditors to use equity receiverships to further their interests in this fashion – namely, fraudulent transfer laws, successor liability, and the absolute priority rule.

US fraudulent transfer is derived from early English law, the Statute of 13 Elisabeth, dating from 1571, which made it unlawful for any debtor to make any transfer to “hinder, delay or defraud creditors.” Currently, 40 US states have enacted versions of the Uniform Fraudulent Transfer Act. Through section 544(b) of the United States Bankruptcy Code (“USBC”), these state law provisions are applicable in bankruptcy case commenced under the USBC. The USBC also includes another fraudulent conveyance provision (s 548), which is applicable only in bankruptcies. Thus, one of the important aspects of US law is that fraudulent transfer law is applicable both within and outside bankruptcy, and therefore applies to out-of-court restructurings.

Successor liability is an exception to the usual rules providing that a purchaser of assets takes those assets free of any debts owed by the seller. Successor liability, however, makes the purchaser liable where there the transaction is of a fraudulent nature or where the purchasing entity is a continuation of the selling entity.

Finally, the absolute priority rule provides that creditors must be paid in full (unless they consent otherwise) before shareholders are allowed to retain their interests in a reorganized company. The landmark case in which these principles were applied to address the problems of equity receiverships was *Northern Pacific Railway Co. v. Boyd*, 228 US 482 (1913).
Many submissions also highlight impediments that the new entity will face in achieving profitability and question whether the management of the new entity will be effective in running the business of the company. It is frequently the case in Western countries, the United States included, that the old management will be completely or partly replaced at some point during the out-of-court restructuring process. Effective management is crucial to the long-term success of any company emerging from a workout: at the time a rescue proposal is approved the plan participants – debtor and creditors alike – are often overly optimistic, but the reality is that corporate failure will be more likely than not. When an SOE is unable to meet the projections that were included in the restructuring plan, the management must be able to react effectively and make the necessary adjustments.

Another area of concern is the need for proper valuations of SOE assets and business plans. Tied to this is the need for adequate disclosure of information throughout the restructuring and the giving of proper notice when assets are being sold.

Requests for further information

Many of the Experts also submitted requests that further information be provided in various areas. For example, they queried:

- Could more data be supplied to substantiate the high success rate claimed for the Changchun approach?
- Does “profitable assets” mean assets only or business divisions (ie whole divisions in themselves)? If the answer is business divisions, are they capable of standing on their own, or will they need to be merged with other stronger business?
- Could more information be provided in respect of the capital funding for the new entity? It appears that since the funds advanced to the new entity by the major bank eventually pass on through and return to the bank, the working capital for the new entity comes from the government, either in the form of funds or land use rights. Further case studies would be helpful on this point, for if the new entity is to survive and prosper, it must have an adequate capital base.
- Does the new company produce a proper business plan including, in particular, cash flow forecasts?
• What protection is given to those workers who do not secure jobs with the new entity?

2. The Study of Relevant Methods, Institutions and Cases Used in Economies Abroad

Summarize any out-of-court approaches in their own jurisdictions, ideally with a view to highlighting some of the following issues:

(1) the incentives/disincentives for using out-of-court restructuring mechanisms;
(2) whether the mechanisms are controlled/administered by the private sector or the public sector;
(3) whether the mechanisms are formal/informal;
(4) who the parties are to out-of-court restructuring agreements;
(5) whether asset management companies ("AMCs") are involved in the process;
(6) carrots (incentives)/sticks (disincentives) for negotiating and reaching a consensus;
(7) frequently used devices for facilitating rescue (eg, debt/equity swaps) or providing exit strategies for creditors (eg, debt trading); and
(8) an assessment of the overall effectiveness and fairness of the procedures.

A few general words about workouts are necessary to put the Experts’ submissions into the proper context. At the heart of all corporate rescue procedures is the need to create more value for stakeholders than will occur if a corporate entity ceases operations and is wound up or liquidated. Traditionally, greater attention has been paid to formal corporate rescue procedures – such as Chapter 11 in the United States. Over the last few years, however, the need for the development of effective out-of-court rescue procedures has become more apparent as a consensus has emerged that formal procedures are not the most efficient way to create this extra value, certainly not in the short term. One of the early responses to the Asian Financial Crisis by multilateral organizations, such as the IMF, was for Asian jurisdictions to enact new insolvency laws. Over the last several years, these
insolvency law reform efforts led to new insolvency laws in many Asian countries (eg, Indonesia, Malaysia, the Philippines, and Thailand). However, a recent study by the Asian Development Bank (the “ADB”) has concluded that the enactment of formal insolvency procedures have not played as important a role in corporate rescue as the development of effective out-of-court rescue procedures. Rather, the study notes that the primary short-term impact of the enactment of these formal procedures is to serve as a backdrop for the out-of-court negotiating.

One of the key proponents of out-of-court rescue procedures has been the international banking community. The efforts of major banks first led to the promulgation of the London Approach in England, which was subsequently adopted in various forms in many other jurisdictions, eg, the Hong Kong Monetary Authority/Hong Kong Association of Banks Guidelines for Multi-Bank Workouts (the “Hong Kong Approach”) in Hong Kong, the Jakarta Initiative in Indonesia, and the Bangkok Approach in Thailand. This, in turn, helped lead the INSOL Lender’s Group to issue its Statement of Principles for A Global Approach to Multi-Creditor Workouts (the “INSOL Lender’s Group Principles”). Most recently, the US delegation to the United Nations Commission on International Trade Law (“UNCITRAL”) has proposed that there should be a chapter in the UN Draft Legislative Guide (which is in the process of being drafted) entitled “Alternative approaches to out-of-court insolvency processes.”

The London Approach/Hong Kong Approach

The London Approach has been very influential in debt restructurings worldwide in general, and in Asia in particular (eg in Indonesia, Thailand, and Hong Kong). Below is an overview of the Approach as adapted in Hong Kong.

1. The Approach only applies to banks.

Since the Approach only applies to banks, it will prove more successful in some situations than others. For example, the Approach will work more effectively where the banks control the majority of debt and are able to pay the other creditors either a substantial portion of their debts or in full in an
effort to prevent the other creditors from taking steps to grab the assets of the company or from petitioning for the winding up of the company. The Approach is less helpful in situations where the banks do not control the majority of debts, such as in rescues involving the construction industry. There are often attempts to gain the participation of bond holders in the process, which is crucial if debt-trading is to be permitted.

The Approach is voluntary, but serves as the “accepted practice of the banking community.” In jurisdictions like the United Kingdom and Hong Kong, the Approach is carried out by private sector firms. In Hong Kong, the Guidelines are carried out under guidelines issued by the Hong Kong Monetary Authority and the Hong Kong Association of Banks, (In other jurisdictions, such as Indonesia or Thailand there is more direct government involvement.)

2. Since it is in the interest of all stakeholders which can include company shareholders, directors, employees, and creditors (which in turn, can include bankers, bondholders and suppliers) for a business to survive, the primary goal of the Approach is for liquidation to be avoided wherever there is a reasonable possibility that the business is viable.

3. The banks must adopt a collective rescue culture mentality. For each bank, this includes:
   • upon learning of the debtor company’s financial difficulties, supporting the company and refraining from taking unilateral steps that although protecting the bank’s interest (e.g. appointing a receiver or suing for repayment) would adversely affect the company’s liquidity and increase the likelihood of its insolvency;
   • sharing information with other banks, including any suspicion or evidence of criminal activity by the debtor company or its shareholders;
   • acting collectively in the making of decisions, including the difficult choice as to whether or not the debtor company should be granted additional financial assistance;
   • not jockeying for special treatment or unfair advantage over the other banks;
• striving to achieve unanimity; and
• declaring any conflicts of interest.

Commentary: This leads to a significant change in the mindset of creditors and the need to avoid the traditional response of rushing in first to grab assets and protect individual positions.

Most formal rescue procedures do not require unanimity of creditors. There usually is a voting mechanism setting forth that a certain percentage of claims (often 2/3 or 3/4) of the creditors present and voting in favor of a plan (and sometimes a majority in number) can bind all creditors who have received proper notice. In contrast, under the Approach, unanimity is required. There can be a problem of holdout creditors under the Approach. (This problem is often addressed by the enactment of an effective, formal rescue scheme that can be commenced to bring a holdout creditor into line.)

4. Obligations of the debtor – the company must be forthcoming with information to its bankers.

Commentary: As with the creditors, this requires a change in mindset. Companies must not be secretive with corporate information, especially with negative news.

5. Banks must develop the expertise to effectively participate in the process and to institute appropriate internal safeguards, including:
• ensuring that their staff is experienced in such matters;
• considering establishing work-out units or teams;
• ensuring that confidentiality is maintained;
• to the extent that it is within their control, ensuring that debtor companies do not breach securities or companies laws.

6. At the heart of the Approach is the voluntary agreement by creditors to abide by a standstill agreement. Workouts are unlikely to be successful in the absence of a standstill. The standstill provides both the debtor and all abiding creditors with a “breathing space” during which negotiations for the workout can get underway. During the period in which the standstill is in effect, the banks normally will agree to a
a moratorium on principal repayments, and sometimes on interest payments as well.

Commentary: The standstill binds only banks. Whether or not other creditors will also agree to abide by the standstill, depends in great part on the extent to which the banks have liaised with other creditors and convinced them of the advantages to be gained by abiding.

7. As a condition for agreeing to the standstill, the banks will often require that the debtor allow the banks to appoint independent financial advisers (e.g. not the debtor company’s auditors) to assess the company’s finances. The expenses of the advisers should be paid by the debtor company and the duties of the advisers shall be set out in a mandate letter.

Commentary: From the perspective of the banks, this is one of the most important parts of the process. It is often the case, especially in Asia, that by the time a workout gets underway the debtor is in a difficult financial position. Companies in Asia do not seek outside assistance as early as their Western counterparts, with the result that when the process does get underway the appointment of outside advisers will be of crucial importance to the banks.

8. Handling of the process – there should be a lead bank and when there are a sufficient number of creditors, a steering committee for the creditors (comprised of creditors with the necessary staff and experience to act in such a role). The lead bank often plays a crucial role throughout the workout process and is usually remunerated by the debtor company for its efforts. The banks generally should be willing to agree to indemnify the lead bank and the members of the steering committee against any expenses and liabilities that they incur when negotiating in good faith.

9. New money and superpriority – A typical workout will not be able to proceed unless the debtor company receives additional funds to enable it to carry on in business or to prepare for an orderly wind down of the business. Where there is unencumbered assets and the need is
urgent, an individual bank may provide funding to the debtor company and in exchange take back a charge over the unencumbered security – but only if when doing so the bank does not prefer itself over other banks in respect of old monies. Where there is not any unencumbered security available, if all of the banks agree, the company may grant the bank providing the additional capital a superpriority charge over other creditors – again, but only if when doing so the bank does not prefer itself over other banks in respect of old monies.

**Commentary:** The providing of new capital to a company in the midst of a workout often makes the difference between the overall success and failure of the workout. There needs to be a mechanism for the granting of charges over unencumbered assets, or superpriority if there are not any unencumbered assets available, to enable a cash-starved company to get sufficient funds. However, it is crucial that the new charge or the superpriority only extend to the new loan and interest thereon and not to the old monies lent by the bank.

10. The sale of debt by banks to third parties can be beneficial and can provide an exit for lenders from the workout. Sellers have the responsibility to notify the buyers of debt of the guidelines in Approach and that they will be expected to adhere to them.

**Commentary:** In his comments, UK Expert Terry Bond notes that although debt trading was initially resisted by banks in the early 1990s, it is now very common in the United Kingdom and the United States. (It is not as well-developed in Hong Kong or in Asia generally.) Although there is the risk that the short-term horizons of some of the purchasers might disrupt the process, this is outweighed by the providing of liquidity, the creation of an exit route, and the entry of new players into the restructuring process.

11. Common aspects of workouts under the Approach to alleviate the financial burden on the debtor company include making additional loans to the company, creditors taking haircuts (ie, writing down part of the loan), debt rescheduling, and debt-equity swaps.

**Commentary:** In his submission, Mr. Bond highlights the changing uses
of debt-equity swaps. He notes that originally swaps were used by banks only when faced with a write off of irrecoverable debt as a long shot hope. Recently, however, he notes that swaps are used on a more constructive basis to help a debtor company re-balance the balance sheet and be able to trade more normally as it exits the workout. In addition, some banks are also trying to better position themselves in cases in which they perceive that there is reasonable upside potential.

In his comments, HK Expert Joe Bannister differentiates between two types of rescues:

- a contract-based settlement between the company and its banks in which existing indebtedness may be rescheduled, additional security taken and repayment arrangements changed or prescribed; and

- a “balance sheet restructuring”, which may take place in conjunction with or subsequent to a contractual settlement, and is likely to involve some or all of the following elements: (a) the agreed sale of non-core assets to other members of a corporate group; (b) the write off or release of part of a company or groups’ debts, possibly in conjunction with a scheme of arrangement under the Hong Kong Companies Ordinance; and (3) the conversion of debt into an equity stake in the business concerned.

Receiverships in England and elsewhere

Although the London Approach is the method used in the UK and many other jurisdictions for out-of-court restructurings, several of the commentators noted that perhaps a better analogy for the Changchun Approach is receivership (prevalent in jurisdictions based on English company law) in which a lender (usually a bank) secured by a fixed and/or floating fixed charge pursuant to a contract with the company appoints a receiver (or a receiver and manager) to take control of the company. The most frequent result is the sale of the company to a third party. The proceeds are used to pay off the secured creditor’s claims, with the surplus payable pro-rata to unsecured creditors, with the exception that in the case of a floating charge, preferential creditors (including certain workers claims and tax claims) must be paid prior to the holder of the floating charge.
Several Experts note that the use of receivers is more prevalent in some jurisdictions than in others. For example in England and Wales, Australia, and Canada it is fairly common for the major bank’s lending to be secured (often through a floating charge over substantially all of the assets of the company). In contrast, in Hong Kong the lead bank rarely has security over substantially all of the company’s assets.

United States

What differentiates the US corporate insolvency system from that of many other jurisdictions is that it is relatively easy for creditors to commence either liquidation (Chapter 7 of the USBC) or reorganization proceedings (Chapter 11) against a company and once the case is underway even the actions of secured creditors are stayed. (Because of these factors, receivership will not be common in the United States.) In addition, in a full Chapter 11 broad avoidance powers are available, burdensome contracts and leases may be avoided, and tax benefits may be available to creditors. These factors loom large in any out-of-court workouts in the United States, because they provide the backdrop for the negotiations.

As US Expert Professor Charles Mooney notes, two motivations for out-of-court workouts in the United States are the savings in cost and time in comparison to Chapter 11. Another US Expert, Alan Kornberg, adds that a workout is less destructive of value than a full bankruptcy and causes fewer problems for relationships with customers, vendors, and employees. Moreover, the debtor’s management almost always would prefer to avoid the public scrutiny and external supervision that is part and parcel of Chapter 11.

Although the US has not adopted the London Approach guidelines, many of the out-of-court procedures in the United States are similar in many respects. For the most part, out-of-court workouts in the United States are handled by the private sector with informal mechanisms. The major financial creditors are the primary participants in the workout and it is not unusual for the claims of smaller creditors to be paid in full. A unique area of US law is the labor collective bargaining agreement, and in some cases it is necessary for the unions to make some concessions to enable the proposal to gain acceptance. It is becoming more common for outside “turnaround” firms to
acquire interests in debtor companies with the hope of using the workout to gain control of the company.

Although there are formal non-judicial procedures for arrangements, compositions, and assignments for the benefit of creditors under state (non-federal) laws, they are rarely used. Growing in use, however, are “pre-packaged” Chapter 11s, in which the debtor and a sufficient number of creditors and interests necessary to approve a Chapter 11 reorganization plan agree upon a workout plan that then becomes the basis of the debtor’s Chapter 11 proposal. This “hybrid” procedure avoids the need for the unanimous agreement of creditors, as would be necessary in the out-of-court workout.

Creditors in the United States are among the most creative in structuring devices to assist with the workout. Mr. Kornberg identifies the following devices that might be used either individually or in combination:

- forbearance while operations recover or market conditions correct themselves;
- amendments to or modifications of existing credit facilities or key contracts;
- refinancing of existing indebtedness by new lenders or investors;
- new investment by current stakeholders or other parties;
- exchange of existing securities for new ones;
- accumulation of outstanding debt claims by “vulture” investors and exchange of such debt claims for control or significant influence over the enterprise;
- conversion of debt to equity;
- sale of all or part of a business; and
- merger with a stronger industry player.

The Resolution Trust Corporation

The Resolution Trust Corporation was established in 1989 to address the problems caused by the collapse of the “savings and loan” (“S&L”) industry in the United States in the 1980s pursuant to the Financial Institutions Reform Recovery and Enforcement Act of 1989 (“FIRREA”). In his submission, US Expert David Leibowitz describes how FIRREA and the
RTC functioned and suggests lessons to be drawn from their use in the context of the Changchun Approach. Upon the failure of an S&L, the RTC was appointed as either a conservator or receiver to preserve and conserve the assets of the S&L. Its functions included carrying on the business of the institutions, collecting obligations owed to the institutions, and selling failed institutions and their assets.

Mr. Leibowitz highlights the RTC’s primary political and economic objectives as follows:

- to keep savings and loan associations open under new management;
- to protect and preserve the rights of the depositors, thus avoiding the need to honor FSLIC’s obligation to pay insurance claims on the deposits of the failed savings and loans; and
- to resolve the assets of the failed savings and loans by collecting as much as possible.

He notes that in China it would appear that there is a similar pressure to successfully handle the assets of SOEs and that the political and social consequences of liquidating insolvent SOEs would be even more drastic to China than the consequences of the S&L were in the United States. He goes on to add that under both the RTC and Changchun approaches, the principal means to maximize value for stakeholders is the “Purchase and Assumption Agreement”. However, he emphasizes that one of the main differences between the approaches is that unlike in China where a new state entity buys only the good assets from the old SOE, in the United States there was an efficient market for selling these assets and it was not unusual for there to be a bidding war for an S&L. Moreover, the purchaser in the United States had to assume 100% of the S&L’s deposit liabilities. He notes that the priority creditors under this procedure were the S&L depositors, perhaps akin to the workers under the Changchun Approach.

He also emphasizes the broad powers that the RTC was given to assist in achieving its goals. These powers included:

- the ability to reject any agreements or contractual arrangements made by the S&Ls that were not made in strict accordance with the S&L’s procedural requirements or the law generally;
• the ability to pursue claims against directors and officers for wrongful behavior; and
• the ability to pursue malpractice claims against professionals of the failed institutions.

Canada

The incentives for participating in an out-of-court restructuring in Canada are similar to those described above for the United States, the United Kingdom, and Hong Kong. However, in spite of those incentives, Canadian Experts Patrick McCarthy and Patrick Shea note that out-of-court rescues in Canada are rare for the following reasons:

• Most insolvent businesses in Canada have a substantial number of day-to-day creditors. Given the high number of creditors, some of them will inevitably resist, or at a minimum decline to participate in, a voluntary restructuring.
• The problem of holdout creditors who try to improve their position at the expense of others.
• The problem of stragglers (creditors whose claims are not identified or identifiable during the negotiations) – this leads to the next problem.
• An incomplete out-of-court restructuring leaves the debtor vulnerable to actions for the full claims of non-participating creditors. This makes it difficult, if not impossible, to induce other creditors and stakeholders to participate and compromise their claims, especially where it appears some creditors in similar positions will be paid in full because they are intransigent.
• The lack of satisfactory information about the debtor and its business operations.

Commentary: They conclude that in Canada a voluntary reorganization without court involvement is most likely to occur where there is a small number of relatively sophisticated creditors whose claims represent the majority of the insolvent debtor’s debt, and there are no material trade or other creditors whose debt needs to be compromised in order for a reorganization to occur.
The frequently used mechanisms in Canada used in out-of-court restructurings, as described by Mr. McCarthy include:

- the reclassification and rescheduling of all or a portion of a creditor’s claim (reclassification as follows: a creditor may have a secured floating charge supporting, for example, $100,000,000 in debt. If the underlying security is worth considerably less than the debt, it is common to see all or a portion of that unsecured debt converted into a subordinated form of debt, or into preferred or common shares, or less commonly for a portion of the debt to be forgiven);

- the consolidation of trade or other debt into a single class, which class receives payments calculated based upon the performance of the company going forward – this allows creditors to eventually have some benefit from their pre-restructuring debt claim (perhaps even payment in full) if the company is ultimately able to resolve its difficulties and prosper, but relieves the company of debt service obligations which may be imperiling its survival.

- debt trading, including as a “liquidity option” in which, as part of a restructuring, a fund of money is made available to allow parties who do not wish to remain in as restructured creditors or equity players for the longer term, to exit from all or a portion of their position, but usually at a significant discount from face value.

Another problem noted by Mr. McCarthy is related to the fact that large creditors are in a relatively stronger position vis-a-vis the debtor than they are in formal insolvency proceedings. There is a tendency for these banks to negotiate quite aggressively and, often successfully, with the debtor, with the result that it is not unusual for debtors to exit the workout with an excessive amount of debt. Such companies will only be able to survive in the long term if the business plan upon which the restructuring was based works perfectly.

Mr. Shea also describes hybrid reorganizations in which under the Canadian Bankruptcy and Insolvency Act, the company’s secured creditors are dealt with privately while unsecured creditors are compromised in a formal proposal which is voted on by the creditors and, if accepted by the required majority of the unsecured creditors and approved by the Court,
becomes binding on all unsecured creditors. The Bankruptcy and Insolvency Act requires that a proposal under the act be made to all of the company’s unsecured creditors, but permits the debtor company to deal with its secured creditors outside of the formal reorganization. The Bankruptcy and Insolvency Act also permits the reorganizing debtor to present a “pre-packaged” plan to its creditors, as was described above in respect of the US approach. However, unlike the USBC there is no cram-down available under Canadian law.

**Germany**

When Germany was dealing with the transformation of SOEs it created a trust institution called the *Treuhandanstalt* to take charge of the process.

**Austria**

The Austrian approach is carried out by the private sector, by debtor companies and their advisers. However, the public sector does play a role through the involvement of the “Associations for the Protection of Creditors’ Rights”. In Austria, these associations are generally entrusted by smaller creditors to represent their interests and ensure that the debtor’s proposal is reasonable and plausible.

A unique aspect of the Austrian approach is that there is a strict time frame set out of only 60 days to reach an agreement. In his submission, Austrian Expert Alexander Klauser describes the typical process as follows:

- (internal) assessment of the insolvency status and the rescue possibilities are set out in a letter to all (unsecured) creditors containing the restructuring proposal;
- individual negotiations with the secured creditors;
- individual negotiations with the unsecured creditors who do not consent readily;
- in case of success and fulfillment of the plan, the remaining debt is usually discharged; and
- in case of no success, judicial bankruptcy or reorganization proceedings are usually initiated.
Unlike under the London Approach and the approach followed in most other jurisdictions, in Austria 100% of the creditors participate in the out-of-court negotiations. The incentives for using out-of-court restructuring methods in Austria include:

- confidentiality and the avoidance of negative publicity;
- speed (a few months versus up to several years in a formal procedure);
- much more flexibility than formal procedures, as long as there is equality of treatment for similarly situated creditors;
- cost-effectiveness;
- lack of judicial control;
- risk of criminal sanctions for offenses committed during the course of the workout (including not paying creditors pro-rata), voidability of such transactions, and even the personal liability of managers.

The disincentives are:

- requirement of unanimity, which can prove problematical because the social security institutions almost always refuse to consent;
- too short a maximum period for concluding the workout. (Mr. Klauser suggests that a 3-4 month period would be more beneficial.)
- difficulty in obtaining new money for the debtor, because there is the possibility that such agreements can be voided if a bankruptcy ensues;
- the public fund to pay workers’ claims for back pay is not applicable to out-of-court restructurings;
- possibility of getting holdout creditors, who must then be offered a high quota or be paid in full.

With the exception of the 60-day rule noted above, there are no other statutory provisions.

*Indonesia*

In the aftermath of the Asian Financial Crisis, Indonesia instituted the
Jakarta Initiative, a variance of the London Approach with more direct government involvement. The Indonesian President appoints a governmental facilitating agency, called the Jakarta Initiative Task Force (the “Task Force”), to facilitate out-of-court restructuring. The Task Force mediates in the restructuring negotiations that take place between Indonesian debtors and their creditors under the Jakarta Initiative, pursuant to mediation rules that it has promulgated. Unlike under the London Approach, the Task Force has the power to require Indonesia debtors to participate in mediation under the Jakarta Initiative. If the debtors prove uncooperative, the Task Force can then report this to the Financial Section Policy Committee (“FSPC”), which has the authority to request the Attorney General to petition for the uncooperative debtor’s bankruptcy.

A case manager is assigned to each potential workout under the Jakarta Initiative. He is responsible for making a preliminary report as to whether the case is a suitable one for mediation and, if so, of the issues to be mediated. If the mediation goes forward, a mediator is appointed with the goal of reaching a negotiated solution. If the mediator determines that an agreement cannot be reached, he calls a final meeting to allow the parties to resolve their differences. The parties have 30 days from the date of this meeting to reach an agreement. If an agreement is not reached, the Task Force may send its final mediation report to the FSBC, which may, in turn, request the Attorney General to petition for the debtor’s bankruptcy in cases where the debtor has acted in bad faith during the mediation.

To address problems in the financial sector, Indonesia established a government agency called the Indonesia Bank Restructuring Agency (“IBRA”). IBRA has broad powers to facilitate restructuring of the banking industry. Needless to say, in its capacity of restructuring individual banks, IBRA is a frequent creditor in restructurings pursuant to the Jakarta Initiative. IBRA is authorized to take control of a bank’s non-performing loans (“NPLs”) and to exercise the underlying security rights. In some cases this control enables IBRA to take control of the debtor company.

Malaysia

In the aftermath of the Asian Financial Crisis, Malaysia established the
Corporate Debt Restructuring Committee (“CDRC”) to facilitate informal corporate rescues. To use the CDCR procedures, a debtor company must satisfy certain eligibility criteria, which include, perhaps most importantly, having a potentially viable business. Negotiations are facilitated by the CDRC’s secretariat at Bank Negara Malaysia. In the workouts, a standstill is put into place and a consultant is frequently appointed.

Malaysia’s response to problems in the financial sector was the establishment of an asset management company called the Danaharta Corporation. Danaharta, like IBRA, acquires NPLs and the underlying security rights. Danaharta participates in the CDRC process – at times as a creditor and at other times as the catalyst for getting a debtor company to use the CDRC process. Danaharta’s powers are quite broad, including the power to appoint a Special Administrator to take control of a debtor company. This power has been exercised 75 times, with 5 successful restructurings to date. Danaharta has proved more successful than IBRA, in part due to the greater powers that it is able to exercise in regard to the corporate debtors within its control. Also, there has been less turnover among high-ranking personnel at Danaharta than at IBRA.

Thailand

In Thailand, out-of-court restructurings are handled by the Corporate Debt Restructuring Advisory Committee (the “CDRAC”) in what is known as the Bangkok Approach and which is derived from the London Approach. The Bangkok Approach is based on the use of two types of formal agreements: the Inter-Creditor agreements (among banks) and Debtor-Creditor agreements (between a debtor and its banks). A debtor initiates the out-of-court rescue process with CDRAC. After approval is gained, the debtor and creditors enter into the agreements. If corporate debtors do not wish to sign Debtor-Creditor agreements they are still permitted to attempt to negotiate less complicated workout agreements.

Essentially, as a result of the financial creditors’ accession to an Inter-Creditor agreement and a Debtor-Creditor agreement, the parties agree to a moratorium for a short period of time so that financial information can be gained from the debtor, a steering committee formed and a debt
restructuring plan developed. Thai Expert George Kelakos notes that while there are some who criticize the CDRAC approach as being overly creditor-friendly, the CDRAC process has resolved many debt restructurings out-of-court. In situations where the debtor is recalcitrant (such as in the TPI case) or in situations where dissenters need to be bound, the parties have recourse to the Thai Central Bankruptcy Court. In many incidents creditors were able to confirm plans of reorganization over a dissenter’s objections and, in the case of TPI, over management’s objections. Thus, like the US procedures, CDRAC procedures can be used to facilitate “pre-packaged” plans.

Mr. Kelakos notes that while the CDRAC process is winding down, with the creation of the new Thai Asset Management Corporation (“TAMC”) by executive decree and its grant of super powers, it will be interesting to see how the powers of the TAMC will play out in the context of a filing under the reorganization provisions under the Thai Bankruptcy Act.

**Japan**

Japan has two types of out-of-court workout procedures, one for smaller cases and one for larger cases, which are described in the submission of Japanese Expert Professor Shinjiro Takagi. The procedures for larger cases offer a more helpful comparison for the restructuring of SOEs. In these workouts (which often involves huge debts), several major banks will gather at the request of the debtor company to negotiate the terms of a partial discharge and extension of payments. The claims of unsecured trade creditors are usually left unimpaired.

The process has been criticized for a lack of transparency. Recently, to promote the writing off of substantial bad debts (which are frequently identified as a major factor in preventing a Japanese economic recovery) in a more transparent fashion, the National Bankers’ Association, the Federation of Economic Organizations, and other entities established a committee to draft “Guidelines for out-Of-Court Workout”, which should be completed by the end of September 2001. It is anticipated that:

- the draft will recommend the use of debt/equity swaps, merger and acquisition, debt trading, and the use of asset management
companies;
- a standstill will apply to financial creditors;
- steering committees and professional advisors are likely to be used;
- unanimity will be required;
- there will be greater transparency than at present; and
- the process will be handled by the private sector without any official governmental authority.

**Nepal**

Based on the Nepalese experience with the restructuring of SOEs, Nepalese Expert Bharat Raj Upreti highlights two aspects:
1. There can be advantages if the old SOE leases (rather than sells) assets to a new company. In Nepal, there have been cases where the period has been set at 25 years or longer.
2. Like the Chinese, the Nepalese have confronted problems with the making of payment to small, unsecured creditors and the settlement of employee claims. These creditors should be provided with special treatment. He notes that the basis can be that such creditors – especially those who have provided raw materials or equipment, done construction or maintenance work, or supplied services – unlike institutional creditors, do not normally receive benefits in the from of interest or service charges.

**Korea**

Korea has established a workout scheme based on “The Accord among Financial Institutions for the Facilitating of Corporation Restructuring” (Corporate Restructuring Accord) among 210 Korean financial institutions. Foreign financial creditors and trade creditors fall outside the accord. The aim of the accord is to set up a voluntary procedure not supervised by the court to enable companies in distress to avoid formal insolvency procedures by entering into Workout Plans and implementing agreements called MOUs. The scheme applies only to banks that have agreed to be bound by their inter-bank accord.

In his submission, Korean Expert Professor Soogeun Oh describes the
operation of the Corporate Restructuring Accord. There are two levels of participants in the Accord: the General Corporate Restructuring Level and the Individual Workout Level as shown in the following chart:

<table>
<thead>
<tr>
<th>General Corporate Restructuring Level</th>
<th>Financial Institutions Accord Operating Committee</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Corporate Restructuring Coordination Committee</td>
</tr>
<tr>
<td>Individual Workout Level</td>
<td>Creditor Financial Institutions Council (Workout Council)</td>
</tr>
<tr>
<td></td>
<td>Steering Committee</td>
</tr>
<tr>
<td></td>
<td>Lead Bank &amp; Creditor Financial Institutions</td>
</tr>
<tr>
<td></td>
<td>Concerned Company</td>
</tr>
<tr>
<td></td>
<td>Major Shareholders of the Concerned Company</td>
</tr>
</tbody>
</table>

A separate Creditor Financial Institutions Council (Workout Council) is established for the workout for each concerned company and determines whether the company may be admitted into the Workout program and whether the proposed plan is feasible and acceptable. The Lead Bank initiates the process by selecting the Concerned Company and calling the meeting of the Workout Council. It is also responsible for drafting the Workout Plan. In cases where the Workout Council cannot reach a consensus, the Lead Bank may apply for mediation to the Corporate Restructuring Coordination Committee.

**Restructuring of subnational government units**

One of the US Experts, Professor Steven Schwarcz, argues that the potential defects in the Changchun approach could be remedied through an approach that has been designed for the restructuring of subnational government units. The essence of this approach are set out his submission:

(1) [O]nly [an SOE] itself, and not its creditors, may commence the debt restructuring proceeding, and must do so in good faith; (2) commencement of such a proceeding automatically stays all debt recovery actions against the [SOE] but interest will continue to
accrue on creditor claims; (3) financiers of the [SOE’s] debt restructuring have priority over claims of other creditors, but the central government [authority monitoring SOE debt restructuring] may scrutinize and object to an excessive amount of new priority financing and condition and monitor its use as appropriate in order to prevent overinvestment; (4) all creditors are bound to a debt restructuring plan that is agreed to by super-majority voting by classes of claims, and, upon such agreement, debts not provided for in the plan are discharged; and (5) the central government [authority in charge of monitoring SOE debt restructuring] may dismiss the debt restructuring proceeding for cause, such as bad faith or unreasonable delay in reaching a plan. Implicit in these rules lies the assumption that the central government will allow the market to work and will not generally act as lender of last resort to the [SOE]. Nonetheless, the central government might consider acting as a lender of last resort where the [SOE] has been economically and fiscally prudent but the factors [necessitating debt restructuring] are largely exogenous, such as a financial market panic.

One of the novel aspects of this proposal is that the SOE/government should have veto power over any debt restructuring that does not preserve a politically acceptable number of jobs for employees.

3. Advice on Related Options, Methods, Policies, and Institutions for the Present and Future Rehabilitation of Distressed Enterprises

As noted above, the current Changchun Approach has the following economic benefits:

1. Profitable assets are freed from the burden of the old debts, thereby freeing up the new firm to better utilize the assets; and
2. Many workers are able to retain their employment, by switching employment from the old to the new firm.
However, these advantages occur to the detriment of creditors generally. Other criticisms were set out in Section II of this Part above. The international trend in out-of-court restructuring – including in Asia – is to put into place procedures that (1) treat stakeholders fairly and (2) ensure that a company that exits from a workout has a realistic chance of succeeding.

The Western approaches and the INSOL Lenders’ Group Principles are discussed for purposes of comparison. They could not be applied to China in toto, for much of their success is tied to the system and business culture of which they are part – a market-based economy in which it is easier to value assets and enterprises; a financial and business culture in which the creditors have access to confidential information of the debtor; and a legal and business culture in which individual parties or committees hire their individual experts for independent advice. Most importantly, the success is tied to the fact that it is up to the parties themselves to decide whether they should agree to a deal – there is no government involvement in the process.

For these Western approaches or models to be adapted for use in China there would have to be more government involvement, as well as a stronger administrative component, to make them successful. It is here that some of the recent experiences in other Asian countries prove helpful, for it is clear that these principles can be adapted for use in Asia and incorporated into existing legal, commercial, and political cultures.

**Recommendation 1:**

China should adopt a Chinese version of the London Approach/INSOL Principles for Multi-Creditor Workout (the “China Approach”) for the out-of-court restructuring of SOEs that incorporates many of the developing international best practices. A governmental, administrative agency should be established to facilitate the use of the China Approach.

**Recommendation 2:**

In designing the China Approach, consideration should be given to
incorporating the following principles:

1. The plan should provide that all creditors are treated as well as they would be treated if the SOE were to go into bankruptcy.
2. Equal treatment should be provided to all similarly situated creditors of the old SOE. This would involve ensuring that all similarly situated creditors receive equal distributions in regard to their pre-existing debts payable by the old SOE.
3. Wherever possible, special treatment should be provided to small creditors – perhaps by paying them off either in full or for a substantial amount of their claims, or by providing them with a priority up to a certain percentage.
4. The decision making process should be more collective and, at a minimum, should involve all of the bank lenders, with voting to be decided on the basis of the levels of outstanding debt.
5. A mechanism should be included to enable dissenting or minority creditors to raise their concerns about the rescue proposal.
6. A maximum time should be provided for the negotiation of an out-of-court workout.
7. Valuations should be done by independent, neutral non-state parties.
8. Proper notice should be given to existing creditors and prospective purchasers when selling any SOE assets.
9. Over time, debt holders should be permitted to trade their claims.
10. Wherever possible, the old SOEs go into bankruptcy as part of the workout proposal.

Recommendation 3:

A Proposal for a Pro-Rata Debt Swap under the China Approach:

<table>
<thead>
<tr>
<th>Old SOE</th>
<th>RMB million</th>
</tr>
</thead>
<tbody>
<tr>
<td>-- total debts</td>
<td>RMB 300</td>
</tr>
<tr>
<td>-- debts owed to State-Owned Banks</td>
<td>RMB 230</td>
</tr>
</tbody>
</table>
Under the present Changchun Approach, the State-Owned Bank will lend RMB 50 million to New Entity (NE), which will pay it to the Old SOE which, in turn, will pay it to the State-Owned Bank in repayment of some (not all) of the Old SOE’s debt to the bank.

An alternative approach would be a pro-rata debt swap achieved by what may be called a scheme of arrangement. (This assumes that the creditors are not holding security.)

1. First, work out the total Old SOE indebtedness, ie, here RMB 300 million.
2. Fix the value of the assets to go to NE, here RMB 50 million.
3. Fix the relationship (%) between (1) and (2).
4. So that, in the above example, for every RMB 6.00 of debt, a creditor is notionally entitled to RMB 1.00 of value in the NE.
5. The plan, after fixing the values and working out what assets to transfer to NE, will propose that creditors vote on the plan – at a single meeting – with each and every creditor getting 1 vote for every RMB 6.00 of debt.
6. A plan (or scheme) will be approved by approval of a majority in value (not also in number) of 2/3 of the creditors present and voting. In other words, as in virtually all instances huge sums are owned to the State-Owned Banks, they will be able to garner sufficient votes to approve the plan.
7. Then, after approval, the existing creditors – all of them, not just the State-Owned Bank – are given bonds in the NE.
8. The bonds would be interest free (or, even better, at a low rate of interest) and become due in stages in, say, 3-7 years’ time.
9. Upon the issue of the bonds, the corresponding amount of old debt to the old SOE would be cancelled (as it is replaced by the new bond).
10. (Arguably, this should be RMB 1 for RMB 1, rather than canceling all the old debts for the new bonds – as this would
involve writing off large amounts of bad debts, which probably is unacceptable for the State-Owned Banks in China at present. Of course, there would be advantages if the old bad debts could be written off and the Old SOE could go into bankruptcy – although this would cause a large one-time hit to the State-Owned Banks, it would strengthen their balance sheets and better position them for long-term growth.)

Advantages:

This swap system or scheme would:

- Avoid the criticism of preferences or fraudulent conveyance.
- Leave the major creditor State-Owned Banks in more or less the same position as under the present approach (because the majority of debt is owed to one major bank).
- Give all the creditors of the Old SOE some involvement in the rescue/restructuring and hence:
  - be more transparent; and
  - create more goodwill for the NE amongst suppliers and trade creditors.
- Leave the NE with a better corporate governance position, as there would be more stakeholders (the bondholders) interested in efficient and effective management.
- Allow greater flexibility for the NE – the bonds would not be secured, which would provide the NE with more flexibility in raising further loans on its land, etc.
- Eventually, allow the bonds to be traded (say, in 12 months’ time).

Disadvantages:

- From the perspective of the State-Owned Bank, unlike the Changchun Approach, all of the money does not go to the Bank – however, as the amount of debts owed to other non-State-Owned creditors (in overall percentage terms) would be fairly small, this should not create a severe hardship for the bank.
Overall Assessment:

Under this proposal, the slightly smaller distribution to State-Owned Bank is more than offset by the gains in transparency and fairness to creditors and the increased goodwill in the NE.

Recommendation 4:

China should establish a separate governmental, administrative agency with powers to take control of an SOE for which the China Approach has not proved successful. One possible model could be the RTC model from the United States. A second model could be the Danaharta model from Malaysia, if the government wishes to directly tie the restructuring of SOEs to the restructuring of State-Owned Banks.

Recommendation 5:

China should enact the following laws to assist with effective out-of-court restructuring:

1. Extending the application of fraudulent transfer/conveyance laws to non-insolvencies.
2. Providing for the ability to avoid agreements made by the SOEs that were not in accordance with SOE procedures and applicable law.
IV. Prospect and Proposals for Debt Restructuring

1. Potential Development of Market-Based Debt Restructuring

Case: Debt Restructuring of Hei Longjiang Glass Factory

Hei Longjiang Glass Factory (hereafter abbreviated as “Hei Factory”) is a state-owned enterprise, which was built in the course of the sixth five-year plan invested by means of “changing allocation funds into loans”, approved by State Planning Committee. It was completed and put into operation in September 1986. Its main product is plate glass and the total amount of investment was RMB 91.20 million. In the first 8 years, the factory’s profits were not bad. But since 1995, it began to run at a loss (and the deficit amount was RMB 17.70 million that year). By the end of May 1998, the accumulative losses had amounted to RMB 130 million. At the same time, the total liabilities of the factory were RMB 275 million and the liabilities-to-assets ratio was 131%. The main reasons for the deficit were: (1) the investment policy of “allocation funds into loans” led to capital insufficiency of the enterprise. So the factory had been shouldering a heavy burden of debts since it was built; (2) the production technology of the factory belonged to the level above average in the same domestic industry when the factory was established, however, it had already fallen behind since 1995, which led to a low product quality and a low-profit result; (3) the prices of raw and other materials rose and the freight was always on a high level (60% to 70 % of purchasing costs). All these situations made the product costs of the enterprise very high. Thus the prices lacked competitive capacity; and (4) the market of plate glass was not prosperous.

Since 1998, the factory has changed a lot through debt restructuring.

A. Setting up a New Company
In June 1998, Hei Longjiang Beifang Glass Co. Ltd. (hereafter abbreviated as “Bei Company” below) was formed. The registered capital amounted to RMB 12.06 million, including state-owned shares (RMB 5.09 million) and shares owned by staff and workers (RMB 6.97 million). The state-owned shares comprised contributions of Qiqihar Municipal Administrative Bureau of State-owned Assets in kind, which stemmed from the assets of Hei Factory for repaying financial loans. Part of shares owned by staff and workers was formed by deferred salaries owed by Hei Factory. In fact, the factory compensated for the salaries by its glass products in the first step and then the workers took the glass products as their investment. These shares were all held by Employee Stock Ownership Committee (ESOC) except for a part of them being held by three major executives of Bei Company in their own names. The ESOC consisted of twenty leading officials coming from workshops and functional departments. It was supposed to exercise equity on behalf of the workers.

When Bei Company was formed, its gross assets were RMB 18.66 million, the total liabilities were RMB 7.76 million and the liabilities-to-assets rate was 42%. The company rented the main working lines of Hei Factory to produce plate glass, and instead of engaging in production itself the latter collected rent only.

Bei Company settled 1,561 employees (64.3% of the total workers of Hei Factory) when it was formed. The retired and other workers of Hei Factory remained in Hei Factory and their lives and medical treatments would be guaranteed by the rental of the production lines which was paid by Bei Company to Hei Factory.

By June 2000, Bei Company had been in operation for two years since it was formed in June 1998. The following problems occurred during this period.

(1) **Serious Deficit.** By the end of June 2000, the accumulative losses amounted to RMB 46.87 million. The main reasons were: (a) the company lacked floating capital after set up, thus it purchased materials mostly by credit. So the prices were comparatively high and the quality was not very stable; (b) in August 1998, the company suffered from an
especially heavy flood, which led to a direct deficit for over RMB 3 million because the communication was broken off; (c) in 1999, the company overhauled its machines and equipment. At the same time, the raw and other materials were in short supply and their quality was not up to the standard as well. These all led to a decreased output, which was only 63% of what had been planned. Moreover, the costs rose (RMB 26.56 higher than the average sale price in the market per heavy trunk). The direct deficit in that year was RMB 36.36 million; and (d) from March to April 2000, the company had to stop production for cool-repairing pit-boilers that were major equipment of glass production.

(2) **Lacking Capital.** Banks had stopped providing any loan to Bei Company since May 1999. So in March 2000, the company had no capital to afford the repair of pit-boilers when it was decided. In that situation, the whole staff pledged their certificates of private deposits voluntarily and got a loan of RMB 800 thousand for the company, the clients paid cash in advance before the delivery of glass, and the company tried to get credit to materials for nearly RMB 6 million. Depending on the cohesion of all the workers and the trust of the clients, the company accomplished cool-repair of pit-boilers in a high quality and in a short time.

(3) **Backward Technology.** The company rented the production lines of Hei Factory whose technique had lagged and lacked the ability to carry on technology improvement or to import advanced lines for glass with floating technology.

B. The “Debts-Equity Swap” for Commercial Creditors

In the first half year of 2000, the demand was vigorous in the glass market of the whole country and the sale quotation was good. The distressed Bei Company saw a gleam of chance to recover and thus began to look for new outlet. First, the company negotiated with the creditor bank and hoped to gain support of a sum of loan. However, the demand was rejected. Then the company turned to negotiate with the four largest commercial creditors, namely the raw materials suppliers of Hei Factory. They are Hegang Mineral Bureau, Shuang Yashan Mineral Bureau, Tangshan Sanyou Alkali Industrial Company Group and Dahua Co. Ltd. Group. After several negotiations the four creditors recognized finally that the liquidation ratio of their claims would be extremely low (even down to zero) if Hei Factory went bankrupt.
Bei Company, however, was the largest enterprise producing glass in Hei Longjiang Province and owned comparatively big market shares and a high-degree fame of trademark in Northeast area. If getting equity to Bei Company, the creditors might obtain long-term benefits from its development. The creditors also noticed that the course of cool-repairing pit-boilers reflected strong internal condensing power in Bei Company. The spirit of sticking together through thick and thin, and strict and effective management all made people feel the inherent strength in the company. At the same time, the relevant departments of Hei Longjiang Province and Qiqihar Municipal Government paid much attention to the existence and development of Bei Company. They acted positively as coordinators and offered great support to the “commercial debts for equity swap” restructuring of Bei Company.

In July 2000, the claims owned by the four commercial creditors of Hei Factory RMB 67.89 million in total were liquidated by assessed parity assets. Then this sum of assets was converted into equity to Bei Company. At the same time, Qiqihar Municipal Administrative Bureau of State-owned Assets allocated assessed assets (RMB 72.33 million) of Hei Factory to Bei Company. Among this sum, RMB 46.87 million would be used to make good the deficit of Bei Company, and the rest was taken as increased equity capital prescribed by the state.

With the increase of capital and shares, the registered capital of Bei Company rose to RMB 154.96 million, which included RMB 80.10 million (51.7% of the gross equity capital) from the state, RMB 6.97 million from the workers, RMB 28.80 million from Hegang Mineral Bureau, RMB 20.33 million from Shuang Yashan Mineral Bureau, RMB 10.10 million from Tangshan Sanyou Alkali Industrial Company Group and RMB 8.66 million from Dahua Co. Ltd. Group.

In the process of restructuring, the assets were evaluated and the general meeting and workers’ congress of Bei Company were conducted on which the plan of increasing capital and shares put forward by the board of directors was passed. The parties signed the agreements on increasing capital officially and went through the formalities of transferring assets and modifying registrations of the company.
C. The Effects of the Debt Restructuring

After the debt restructuring through “debts for equity swap” and the state’s investment, Bei Company became a state-held company of limited liability with multi-investors. Remarkable changes occurred in its finance and operating situation.

1. The quality of assets has been improved. After the company having been invested capital and increased shares, the gross assets were RMB 248 million and the total liabilities were RMB 96.50 million. Its liabilities-to-assets ratio was 38.9% (107% previously). And its ratio of floating assets and ratio of quick assets were 0.56 and 0.34 respectively.

2. Losses were put to an end. Granted by Qiqihar Municipal Committee and the government, the allocated assets in capital received were used to write off or decrease the accumulated losses (RMB 24.87 million), while the excess part of the costs of products in stock than their sale prices was listed as annual accumulated losses to be written off or decreased. Through this adjustment, the accumulated losses of the company were offset. By the end of June 2000, the company made even in beneficial results.

3. The operating benefits have been improved. After becoming stockowners of Bei Company, the four major suppliers have been supporting the operating and production of the company by the means of supplying goods before settling accounts and settling accounts in preferential prices as well. In 2000, the sales of Bei Company were RMB 38.14 million and the gross profits were RMB 420 thousand. This was the first time that the company gained profits and paid about RMB 120 thousand dividends to stockowners. By the end of the first half of 2001, the amount of accumulative sales reached RMB 41.05 million and the accumulative profits were RMB 2.71 million.

4. The credit to the bank is good. After formation, Bei Company opened an enterprise basic account in Construction Bank and got two sums of closed loans amounted to RMB 14 million. Up to now, the company has been paying the interests in full on time though the principal has not been repaid so far. By the end of 2000, the interests that had been paid were RMB 470 thousand in total.

5. The employees’ work status is stable. After restructuring, the workers’
employment posts and income are all comparatively steady because the production and operation of the company have been led onto the correct path. At present, the workers’ average wages are over RMB 600 per month.

D. Bank Creditors’ “Debts-Equity Swap”

By the end of April 2001, Hei Factory had 2,429 employees. Its gross assets were RMB 8.3638 million, the total liabilities were RMB 204.049 million and the liabilities-to-assets ratio was 244%. Among the debts, RMB 108 million were of the principal and interests of the loans from Qiqihar Branch of Bank of China and it has been transferred to China East Assets Management Company now. There is a mortgage on this sum of claim and the securities are mainly machines and equipment of Hei Factory. Currently, Bei Company and China East Assets Management Company have already reached to a general agreement that the securities will be evaluated as RMB 26 million and then be invested into Bei Company, and Bei Company will have to repurchase this part of shares in the 6th year after the investment. But by the time this report was completed, the two parties have not signed the relevant legal documents formally yet.

E. The Fate of the Old Enterprise

In June 2001, Hei Factory applied for bankruptcy to Qiqihar Intermediate Court according to the Enterprise Bankruptcy Law and entered into bankruptcy proceedings.

Several Enlightening Points from “The Restructuring Case of Hei Factory”

The case of Hei Factory is of very typical significance. It not only shows that there is a huge potential of debt restructuring in China’s state-owned industrial enterprises, but also indicates that Chinese are intelligent and creative in the practice of saving industrial enterprises. In general, we may at least obtain several enlightening points as follows.

Commercial claim has the potential of taking part in restructuring. In
the case of enterprise bankruptcy, the order for commercial claims to be paid is in the last and the rate of repayment is the lowest. Therefore, the commercial creditor should have the good reason to participate in the restructuring of the debtor-enterprise positively. And because of the principle that “all the participants will be benefited” pursued in the restructuring practice, the sooner the creditor takes part in, the more priorities and favor he will get in the payment.

What is different in this case from the Changchun Purchase-Sale Restructuring Approach is that the commercial creditors took part in the restructuring transaction, they had no qualification or ability to provide loans. So they adopted a kind of “debts for equity swap” method, making use of the assets to pay the debts and then to invest. Its formula is:

\[ \text{Claim} \rightarrow \text{Repayment in the assets of the enterprise based on their assessed value} \rightarrow \text{investment to the new enterprise in the assets evaluated} \rightarrow \text{equity} \]

If this kind of “debt-equity swap” may reach to certain scale, it means that a set of profitable assets with independently running ability (e.g. production lines) can be hived off from the old enterprise and changed into the assets of the new enterprise formed by stockowners’ subscription. Moreover, this kind of stock ownership has not the necessity to be repurchased (i.e. turning into claim again) in several years as the FMAC usually requires, and therefore is more beneficial to the long-term development of the new enterprise.

Commercial creditors’ participation in the restructuring is of special positive significance. First, it offers the enterprise indirect source of financing. Commercial creditors are usually the suppliers of the enterprise. When they become stockowners of the new company, they would rather sell on credit and give price preferences based on mutual benefits and trust. Credit sale itself is a kind of commercial credit, which can replace the loan of floating capital from banks as a financing method. Furthermore, the sort of commercial credit can save the financial costs (interests) of bank loans and increase profits of the enterprise, and can thereby benefit the national treasury (by income tax) and stockowners (by dividends) as well. In addition, this kind of commercial credit brings to the suppliers who are stockowners
themselves the advantage of broadening marketing channels for their own products.

Another significance of commercial creditors’ participation in the restructuring is that it can be a pressure on bank creditors and thus impel them to take more positive attitude to the restructuring. For a long time period, the passive attitude of bank creditors has been becoming an important negative factor for enterprise restructuring. In the case of Hei Factory, we can see that the liquidation ratio that the four commercial creditors achieved was all 100%, while the liquidation ratio the banking creditor could hope to get relying on the mortgage was only 24%. If the bank creditor was not so indifferent to the suggestion of restructuring given by the enterprise at first, it could be completely possible for him to get much higher repayment by taking part in the restructuring negotiation. From this we can learn a lesson: The rule of “all the participants will be benefited” has brought about certain opportunity value. Anyone who ignores this value will have to pay price.

Claims may become an instrument of payment in assets transactions. One of the characteristics of the Hei Factory case is to mobilize creditors to obtain the assets of the old enterprise by using claim as an instrument of payment when unable to get bank loans necessary for the assets purchase, and then to invest these assets into the new company so that profitable assets were transferred successfully. Creditors who took part in this kind of debts for equity swap could be commercial creditors, staff and workers, local government, and FAMC. When claim can be transacted with profitable assets and transformed into the form in which the creditors may realize their benefits, we can see the prospects that more creditors will be glad to take part in the restructuring and thus fair liquidation will come true to a higher extent. At the same time we can see the prospects that the new company may gain increased financing by more flexible methods on the basis of common benefits. In fact, the method of hiving the profitable assets partly off from the old enterprise by “debts for equity swap” can also be used in the Changchun Purchase-Sale Restructuring Approach. In this way, the interests of middle and small creditors will be taken care, and moreover, the new company’s amount of debts can be decreased and the amount of assets received increased.
Financial Assets Management Corporation (FAMC) should have more flexible methods to deal with claims in addition to the model of “debts for equity swap plus purchasing back”. According to a recent report, FAMC has the intention of selling claims at a discount or even getting them auctioned publicly. No medicine can cure all the diseases, so there is no any model that may be unchanged all the time. The best way is to take part in the negotiation with enterprises and other creditors actively and positively, and to seek for more reasonable solutions in the negotiation.

The manner of governments’ investment in the new companies needs further improvement. In the case of Hei Factory, the practice that the government invested a part of old enterprise’s assets into Bei Company needs to be analyzed specifically. It is irrefutable if the investment was the land using right only. But if other assets were involved, the legal rights and interests of the creditors would probably be damaged when these assets were picked out as investment. Therefore, equity formed from these assets should be possessed by the old enterprise and if the old enterprise goes bankrupt, they should be counted into insolvent properties so as to be used for bankruptcy liquidation distributed through cashing or equity.

We can gain an enlightening point here: when the government changes the old enterprise’s land-using right into state’s investment to the new company, buildings on the land will be transferred to the new company at the same time according to the principle of “the ownership of buildings gone with the land”. In order to decrease the negotiation costs for rescuing enterprises and to realize effective usage of resources, such measure can be adopted as converting part of the assets into investment to the new company while allocating corresponding shares to the old enterprise, so that the old enterprise can repay its debts to its creditors by transferring the equity of the shares or bankruptcy liquidation.

The cultural value of enterprises should be valued. The cohesion, spirits of the workers of loving the factory and being responsible for the job, and strict management and organization as well are all precious wealth of an enterprise. At the most critical times of Bei Company for lack of money, it is the unselfish contribution of the workers that saved the enterprise. There is a profound truth in this moving story, that is, state-owned enterprises possess a
sum of special intangible assets. We can conclude that whether a state-owned enterprise in serious distress can revive or not is determined not only by the quality of its material factors such as assets, increased investment, technology, market, etc., but also by the quality of its non-material factors such as enterprise culture, organization and management, manager team, professional technology team, etc. Observed from the above case, the internal condensing power of Bei Company came firstly from the excellent tradition formed for a long time, and secondly from the institutional mechanism of ESOP. The “claims into shares” of the workers decreases the government’s financial pressure, and makes the material form of depreciation of employee’s labor force transferred from cash to equity with higher risks. Actually, it is the workers who stand out again to take the risks and costs of economic reform. In this sense, governments, and even the whole society, have the moral duty to stand by restructurings and revivals of state-owned enterprises.

2. Theoretical Summary on Practices of Debt Restructuring

According to the cases and analyses above, the success of debt restructuring of SOEs of China can be theoretically summed up as follows:

1. To be specific, the most contribution of the practices of debt restructuring either in Changchun or in Helongjiang has not only provided some kind of approaches for reference, but also proved a simple and profound truth that we should keep on developing and utilizing market methods and market resources rather than simply rely on the policy tools and governmental resources to rescue the SOEs.

2. If we say that the approaches of Changchun used the transferability of assets successfully, then the case of Helongjiang Glass Factory used the transferability of creditor's rights effectively. The market transaction of assets and that of claims is of significance in using market means and resources to restructure the debts of SOEs.

3. Of course, governmental functions and state-owned economic resources are also very important. As to the functions of government, the function of being owner and that of coordination
are the most basic. The goal of the function of being owner is to push assets of the enterprises into market. The process of assets transaction in the debt restructuring is in some degree the process of putting state-owned assets into market. It is impossible for the problems concerning the debts of SOEs and settlement of workers of SOEs etc. to be put into market if the state-owned assets are not put into market. The primary significance of the function of being coordinator lies in promoting the negotiation between the related parties and eliminating sorts of obstacles and resistance from governmental power system. In order to carry out these functions more effectively, it is considerable to establish a kind of special government agency. To avoid repeating the old manner of the government taking care of everything, it needs to clarify the tasks and functions of such a special agency by virtue of laws and regulations.

4. As to the function of resources of state-owned sector, two main parts need to be paid attention to in the process of debt restructuring: resources in stock and increased resources. There are two most important kinds of resources in stock. One is aggregated working assets such as all kinds of economic resources tangible or intangible, monetary or material, substantial or manpower, listed in the book or not in the book which may contribute directly or indirectly to the profits of the enterprises. Another is the right of using land. Meanwhile, increased resources comprise of two parts. One is financial revenue received, and the other is financial revenue receivable. The received is invested mainly in the way of direct or indirect financial funds or financing, while the receivable is invested in the form of reduction, postponement and exemption of taxes payable and fees for transferring the right of using land etc. Besides, the financial policy, industrial policy, basic infrastructure construction, financing technical innovation, and social insurance made by the State should provide favorable conditions for rehabilitation of SOEs.

5. The valuation of assets and business prospects of enterprises before the restructuring of the enterprises is critical for the success of the restructuring. It should be noted that the valuation could not be solely made based on the financial statement or the achievement in
the production and sale. In the valuation of assets and business anticipation, the comparison of the going-concern value with the liquidation value should be paid attention to, and the ability of production, occupied shares in market, competition, profits, technology exploitation, investment attraction should be evaluated synthetically.

6. Restructuring plan is the result of the negotiation among multi-parties. The disclosure of information during the restructuring is one of the most important conditions needed to get the assistance of the creditors. Restructuring plan should be approved by multi-parties such as the workers, the department of government in charge, and the creditors. The plan should be made according to the concept and methods of market transaction, and based on equality and willingness. In the making and execution of the restructuring plan, intermediaries such as lawyers, accountant, assets assessor, investment consulting company, and assets entrust company etc., will play an important role.

7. It is especially important for restructuring and recovery of SOEs to respect the democratic rights of the workers and rights and interests of laborers well enough. It is not only because of the special position of workers of SOEs based on the historical and legal reason, but also because of the special contribution of their technology, organization, discipline, and perfect characters to the intangible assets of the enterprises.

8. Concession of the creditors and input of increased assets are two conditions indispensable to successful restructuring and rescuing of enterprises. Creditors should make certain about their boundaries of concession contrasted with the rate of repayment in the case of bankruptcy liquidation. Creditors’ overemphasis on their own interests and persistence in non-concession is in fact irresponsible for their own interests. To save their interests at the same time of rescuing the enterprises, the creditors should do their best to “inject

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38 Article 9 of State-owned Industrial Enterprises Law of the People’s Republic of China, still effective now, stipulates: “The state safeguards the owner position of workers, and the lawful rights and interests of workers are protected by the law.” Article 10 stipulates: “Democratic management is implemented in the form of workers’ representative assembly and other forms.”
blood” into the enterprises in all kinds of ways. Meanwhile, it is feasible and beneficial to introduce investment from third parties in many ways.

9. It is only the beginning of recovery of the enterprises to improve their financial positions through debt restructuring. To gain the survival and development in a long term, the enterprises should carry out their re-capitalization and technology improvement, optimize their mechanism of operation and strengthen their positions in the market continuously. The re-capitalization of the enterprises can go along with the transformation of SOEs in line with the stock system.

10. Since before the restructuring, the old enterprises were insolvent and part of the assets were ineffective, it is an inevitable and unavoidable fact that creditors’ rights will be devalued. Therefore, one of the tasks is to allocate the losses of the creditor’s claims impartially. One form of the allocation is to dispose of the creditor's claims at a discount in the transaction. The other is to extinguish the claims after the bankruptcy liquidation of the old enterprises.

11. The principle that “all the participants will be benefited” from the debt restructuring is good to encourage the transfer of constructive assets and active concession of creditor's claims, which may save the cost of the negotiation. It should be noted that all the creditors should be given the equal opportunities to participate in the restructuring.

12. In short, the coordination of multi-goals should be achieved in the debt restructuring of enterprises. In various debts restructuring of enterprises hitherto, there are three goals to be attained. The first one is to relieve the distressed enterprises (or at least to rescue the profitable assets of the distressed enterprises); the second is to keep employment and settle the workers; the third is to protect the claims of financial creditors, especially those of bank creditors. All the goals are the social issues that lead great pressure to the government at present, and the practice has proved that the three goals can be attained in one go. However, few people place the achievement of fair repayment to all creditors in the prominent or at least an important position. The issue of the achievement of fair repayment to all creditors may be not urgent to the government at
the moment, but for a long run it should be attached importance, because fairness and good faith are vital to establish a healthy and efficient market. Therefore, how to realize the coordinated achievement of the three goals is a topic waiting for further study.

3. Improvement on the Model of “Purchase-Sale Restructuring”

**Improved Model 1** The feature of “Purchase-Sale Restructuring” (PSR) in Changchun City is making the assets float to cause the changes of debts. Thus this model can be improved when the main creditor is not a bank but a commercial or an assets management company (AMC). The following Chart 3-1 is an improved model that can be adopted by an AMC (or by a commercial creditor).

![Diagram of Improved Scheme for PSR Assets Transactions](chart3-1)

**Chart 3-1** Improved Scheme for PSR Assets Transactions

The transaction shown in the above Chart mainly includes three steps:

1. AMC transfers its claim to the old enterprise to the new company at an assessed price. And the new company will deliver part or whole payment at a future time or convert the assigned claim into equity shares.
2. The old enterprise transfers its profitable assets to the new company at a contractual price.
3. The claim that the new company gets from the new company is offset by the payment to the old enterprise in the assets transaction.

**Improved Model 2** If we combine the scheme of Chart 3-1 with Chart
we can have Chart 3-2 as another transaction model, that is, the bank transfers part of its claims to AMC, then AMC converts the assigned claim into equity shares of the new company according to Chart 3-1, the rest of the bank’s claims can be dealt with according to Chart 2-1. The advantages of this transaction scheme are: first, it can make a great number of profitable assets revived; second, the bank gets an higher rate of discharged claim with less money; third, the new company has less debt burden after the transaction. This scheme is suitable for those large and old enterprises that have a great number of profitable assets.

Chart 3-2  Improved Scheme for PSR Assets Transactions (2)

**Improved Model 3**  Based on Chart 3-2, the old enterprise can pay the compensation of status-conversion to its employees in profitable assets, and the employees convert those profitable assets into equity shares of the new company. Thus the following Chart 3-3 is formed. This scheme reduces the cost of assigned assets and betters the new company’s financial structure. On the other hand, it protects the employees (including those who do not work in the new company) and reduces the burden of government in settling workers.
Chart 3-3  **Improved Scheme for PSR Assets Transactions**

**Improved Model 4**  If we substitute “commercial creditors” for “employees” in Chart 3-3 it is also practicable. Adding “commercial creditors” to Chart 3-3, we can get Chart 3-4.

Chart 3-4  **Improved Scheme for PSR Assets Transactions**

Apart from the advantages of the above three models, Model 4 has
another advantage, that is, all creditors can participate in the restructuring transactions and get relatively fair treatment. Thus they all benefit from the rescue of profitable assets in the old enterprise.

**Improved Model 5** When there are lots of small creditors, in order to reduce the negotiation costs and protect their interests in the restructuring transaction, we may design a transaction scheme shown in the following Chart 3-5.

![Chart 3-5 Improved Scheme for PSR Assets Transactions](chart)

In the above transaction, the bank provides two loans to the new company. One is used as a part of payment for buying the profitable assets of the old enterprise (and the latter will use this payment to discharge its debts to the bank). The other is used to buy the small creditors’ claims at a discount (the discount percentage can be made according to the discharged claim rate, which would be gotten if the old enterprise were bankrupt). Then the new company enables those assigned claims to offset the rest part of payment for buying the profitable assets. The latter loan can be given to an intermediary institution, then the institution allocates it among the small creditors according to their own individual percentage of the total transacted claims. For instance, if the old enterprise has profitable assets of 50,000,000, the total small claims are RMB 20,000,000 and the discharged claim rate in bankruptcy is 15%, thus the new company will borrow two loans RMB 50,000,000 in total from the bank. And one loan of RMB 47,000,000 will be paid to the old enterprise (the latter will then pay it to the bank), the other loan will be paid to the small creditors. This model can be combined with Model 3 and Model 4 when used.
**Improved Model 6** When there is a purchaser, who is usually a large-sized enterprise or foreign consortium, the bank loans to the purchaser, and the loan and other assets are invested to form a new company that will then carry out the debt restructuring of the old enterprise according to the above schemes. The advantage of this scheme is that the liabilities of the new company will be greatly decreased, and the new loans of the bank will get more reliable security of repayment based on the assets of the purchaser. To the purchaser, the cost of the purchase will be much less than that of the direct merger. Chart 3-6 is a scheme of assets transaction improved on the basis of the improved model 5, and the same changes can also be applied to the other models.

**Chart 3-6** Improved Scheme for PSR Assets Transactions

**Other Factors May Be Added** The following factors might be added to the above models:
- The government’s investment in the way of funds and land using right.
- The government obtains the profitable assets from the old SOE as repayment financial loans and converts them into investment in the new company.
- Claim transfer among creditors.
- The new company rents some of the residual assets from the old SOE and gets the right of preemption in future.
- The new company leases the government-invested land using right to the old SOE and uses the rent as consideration for renting the latter’s assets.
- The third party’s participation in restructuring transactions by
purchasing claims to the old SOE.

- The third party’s participation in restructuring transactions by purchasing claims or equity to the new company. Furthermore, some steps shown in the above Charts can be omitted or modified. For instance, if sufficient profitable assets can be transferred to the new company by virtue of “claim→assets→equity” method and all of bank claims are disposed by AMC according to Chart 3-1, thus the starting step by a loan from bank can be omitted in “purchase-sale” transaction.

**The Application of Trust System.** The *Trust Law* of the People’s Republic of China issued recently will take into effect on October 1, 2001. Trust system established by the Law proposes new approaches of the enterprises’ debt restructuring in suspending the claims, exercising the rights of creditors collectively, and separating the profitable assets. To be specific, there are following approaches:

- **Assets trust and claim trust in the restructuring transactions.** Based on the unanimity or majority resolution of the creditors, the enterprise debtor can entrust the profitable assets to a trustee and appoints the creditors as the beneficiaries, and at the same time the creditors can entrust the claims to the trustee appointing themselves as the beneficiaries. Managers or the new team of managers of the old enterprise will run the profitable assets as the trustee or employees hired by the trustee. Since the profitable assets have the independent status as trust property and have been distinguished from the other assets and civil liability of the settlor, i.e. the old enterprise, the profitable assets will never be the targets of individual claims and enforcement of the creditor. And meanwhile once the claims are entrusted to the trustee, they are out of the control of the settlor and the creditor as well, so that the creditors can not exercise the rights individually. Thus, a system of collective payment will come into being and the unfair payment leading to the preemptive strategy of individual creditor can be avoided.

- **Right trust in the restructuring negotiation.** During the negotiation of the restructuring (whatever the model adopted in the end), the medium and small-sized creditors may entrust their claims to an intermediary institution that will independently participate in the negotiation, decide the concession, and sign on the agreement. It is advantageous to the medium and small-sized creditors in decreasing the cost of the
negotiation and strengthening the position of their negotiation. Meanwhile, it also facilitates the dialogue between the debtor and the primary and medium and small-sized creditors, and increases the efficiency of the restructuring procedures. This approach usually comprises of part of the above trust of the claims, and sometimes can be also exercised itself. The participants of the trust may not necessarily be the whole or majority of the creditors and it can also be applied in the case of one or more creditors included in the trust. Additionally, the owner of the enterprise may entrust the enterprise to a company or intermediary institution that will take over the assets and the liabilities and negotiate with the creditors based upon that.

- **The method of trust can also be flexibly applied to the above models.** For instance, the equity of the employee in Chart 3-3 and 3-4 can be entrusted to the trustee, and the approach of trust can also apply to the transaction of purchasing small claims in Chart 3-5 and 3-6, which means that the small creditor entrusts his claims to the trustee and the trustee negotiates with the new company and distributes the money paid for the transfer of claims proportionally.

- **Trust in profitable assets.** Under the unanimous agreement of all creditors and the agreement with the old enterprise, the old enterprise pays to the creditors collectively for the debts by the profitable assets (the rate of repayment and the proportion of allocating the benefits are conducted in accordance with the agreement). All the creditors are beneficiaries. The profitable assets are trust property, and controlled by the trustee, who may be one company or a team formed by several companies, and the workers of the old enterprise will be hired to run the operation. If the profitable assets have been mortgaged, the mortgagee can entrust the assets and make himself as the beneficiary. Under this situation, the settlor has obtained the status as assets successor similar to that of the new company in Changchun Approach. The difference is that the settlor does not have to pay consideration in gaining the profitable assets, therefore, there is no need to get loans and purchase claims. However, it is a problem for the settlor to have capacity to activate the profitable assets and improve the motivation mechanism. As to whether the settlor may dispose the trust property or use it to re-invest, it is subject to the clauses made when setting up the trust or the decision made by all creditors.
4. Systematization of Debt Restructuring Process

Objectives and Principles of the Procedural Systematization

There are three basic objectives essential to the issue of the procedural systematization, which are legality, efficiency, and justice. Legality refers to not only acting in accordance with the norms of civil law, but also in conformation with the norms of related commercial laws and economical laws, in which there are some noticeable laws such as bankruptcy law, corporation law, bank law and financial trade law, land administration law, labor law, tax law, accounting law, accounting guide-lines, laws and regulations related to the administration of state-owned assets, management laws and regulations on the registration of industrial and commercial enterprises. Legality of transaction is the basic safeguard to achieve the efficiency and justice of the deal. If the floating of property, disposal of rights, exemption of obligation, and alteration of judicial person, etc., break the relevant law in the transaction of the enterprise’s restructuring, there will be disputes, lawsuits, legal sanction, and the economic losses resulted. Since the legal relationship involved in the transaction is very complicated, experts will be needed to supply professional service. At present, there is fairly low rate of making use of the lawyers’ service in the local debt restructuring transactions, which is due to the inadequate knowledge of the legal issues in the enterprise’s restructuring and the shortage of the professionals in many places.

As to efficiency and justice, there lies undoubtedly a certain contradiction between both. The negotiation with multi-parties has not been realized and is very difficult to realize at present. It is a remarkable progress for the Changchun Approach to offer the full opportunity of participation in the restructuring to the primary creditors and the employees. It is a problem worthy of studying how to further give medium and small-sized creditors the chance to participate in the deal. There are at least some factors to be considered as follows:

- Motivation of banks’ participation. When the profitable assets are much less than the value of bank claims, the less the participating
creditors there are, the more interests of banks can get. Therefore, from the instinct of the market participant, the bank prefers to make a deal with the enterprise debtor individually (i.e. secret deal). It is common that the efficiency of the individual deal between the enterprise and the primary creditor is higher than that of the collective deal with many medium and small-sized creditors participating in. In spite of the blame such as “lack of justice”, as discussed above, the approach of individual deal is not banned by the current law of China and it is usually understood and recognized by the government. Moreover, confronted with the inevitable future losses of claims, the bank has to provide a sum of considerable increased loan in the “Purchase-Sale” restructuring. Based upon this situation, it is indeed difficult for them to accept the requirement that the medium and small-sized creditors participate in the restructuring transaction and share the output. Thus, it is an issue worth studying how to involve more creditors in the restructuring deal.

- **Cost of negotiation in divergence.** In the case of many creditors participating in the restructuring transaction, inevitably there must be conflict of interests in the participants. With the limited benefits divisible, everyone tries to maximize their own interests, however, one of the expectable objectives in the restructuring is to reduce each interests. Lack of the enforcement of the law, the agreement of complete unanimity on the restructuring will never be obtained without the rational balance and concession of all the participants. Therefore, it is a difficult problem how to unify and coordinate between the efficiency objective of cost reduction and the justice goal of expansion of negotiation.

- **Debt claim to individual creditor.** The agreement in the regime of civil law can not bind the creditors out of negotiation. Therefore, there is an embarrassing situation to be faced with in the debt restructuring purely based on the concession of part of creditors. That is, due to the concession and efforts made by the participants in the restructuring, the finance of the enterprise gets better. Then, the creditors without participating in the deal exercised their recourse through lawsuit or enforcement process, which pushed the enterprise with the hope of survival to death, and also made all other creditors’ previous contributions to rescuing the enterprise wasted. The creditors’ anticipation of such result may always shake their confidence in the
restructuring. But such disadvantages can be avoided after the profitable assets were legally hived off according to the approach of Changchun. However, what can not be avoided that individual creditor still has chance to claim debts individually before the completion of the restructuring transaction. Especially when they were aware that the restructuring transaction was going on, they would use the preemptive strategy losing no time to attack the property of the debtor. This is also a reason why the primary creditor would not like to negotiate in public and in large scale. Therefore, it is an urgent problem to be resolved how to create the measures of protection in the restructuring negotiation to ensure the achievement of the policy objectives such as the rescue of the enterprise, the employment of the workers, the protection of the financial claims.

- Clarification of relevant policies and regulations. A series of policy issues involved in the restructuring are needed to be cleared and defined such as the disposal of state-owned assets, bank claims, and workers’ compensation transformed into equity. A series of operational issues involved in the restructuring also need to be standardized such as valuation of assets, appraisal of claims, confirmation of equity, investment of the right of land using. When the relevant policies, regulations and acts are not clear, the local governments and the banks will be full of worries, and there may be many difficulties and disputes in the operation. Some parties may make use of the unstable factors as the means to challenge the legality of the restructuring scheme and to seek for favorable status in the negotiation. Consequently, it is urgent now for the promotion of restructuring and reliving the distressed SOEs to enact the related administrative regulations.

The key of the systematization of restructuring process is to establish a series of systemic jurisprudence, which not only embodies the special legislation of debt restructuring, but also more chiefly expresses the cooperation with related laws under certain principles. There are some recommendations concerning the debt restructuring out of court proposed by some international organizations. Two examples are cited below.

A. The Principles Proposed by the World Bank
In April 2001, the World Bank published a report “Principles and Guidelines for Effective Insolvency and Creditor Rights Systems”, in which Principle 25 and 26 provide the basic opinions on out-of-court debt reconciliation and debt restructuring. The two principles are:

**Principle 25: Enabling legislative framework.** Corporate workouts and restructurings should be supported by an enabling environment that encourages participants to engage in consensual arrangements designed to restore an enterprise to financial viability. An enabling environment includes laws and procedures that require disclosure of or ensure access to timely, reliable and accurate financial information on the distressed enterprise; encourage lending to, investment in or re-capitalization of viable financially distressed enterprises; support a broad range of restructuring activities, such as debt write-offs, rescheduling, restructuring and debt-equity conversions; and provide favorable or neutral tax treatment for restructuring.

**Principle 26: Informal workout procedures.** A country’s financial sector (possibly with the informal endorsement and assistance of the central bank or finance ministry) should promote the development of a code of conduct on an informal out-of-court process for dealing with cases of corporate financial difficulty in which banks and other financial institutions have a significant exposure—especially in markets where enterprise insolvency has reached systemic levels. An informal process is far more likely to be sustained where there are adequate creditor remedy and insolvency laws. The informal process may produce a formal rescue, which should be able to quickly process a packaged plan produced by the informal process. The formal process may work better if it enables creditors and debtors to use informal techniques.

**B. The Principles Proposed by the INSOL International**

The INSOL International published the “Statement of Principles for a Global Approach to Multi-Creditor Workouts” in October 2000. It generates the practice and experience of various countries and puts forward to eight principles as below:

**The First Principle**

Where a debtor is found to be in financial difficulties, all relevant creditors should be prepared to co-operate with each other to give
sufficient (though limited) time (a “Standstill Period”) to the debtor for information about the debtor to be obtained and valued and for proposals for resolving the debtor’s financial difficulties to be formulated and assessed, unless such a course is inappropriate in a particular case.

*Points emphasized in the Commentary:*

- The workout should apply to all creditors whose co-operation is needed to make any attempted workout or rescue succeed. Therefore it is necessary to identify the classes of creditors to be included in the process and then to decide which creditors in such classes should be included.
- As a rule, all financial creditors should be included, regardless of the fact that some creditors may have less exposure than others, since their relative conditions will change from case to case.
- In regard to non-financial creditors, whether or not they are included depends on whether their inclusion will enable the rescue to progress.
- Where bonds or traded debts are involved in the rescue, it is common to include representatives of these creditors rather than all of the debt holders.
- The interests of financial creditors will usually be better addressed by the creditors acting in co-ordination and abiding by the standstill rather than pursuing individual self-help remedies.

**The Second Principle**

During the Standstill Period, all relevant creditors should agree to refrain from taking any steps to enforce their claims against or (except for the disposal of their debt to a third party) to reduce their exposure to the debtor but are entitled to expect that during the Standstill Period their position relative to other creditors and each other will not be prejudiced.

*Points emphasized in the Commentary:*

- Retain from taking any steps, including (1) not to press for repayment against the debtor, (2) not to try to improve their individual positions relative to other creditors by obtaining or enforcing security or seeking additional preferential treatment, (3) to leave existing lines of claims in place.
- Their position relative to other creditors will not be prejudiced.
The Third Principle
During the Standstill Period, the debtor should not take any action which might adversely affect the prospective return to relevant creditors (either collectively or individually) as compared with the position at the Standstill Commencement Date.

Points emphasized in the Commentary:
- In exchange for the agreement of the creditors to abide by the standstill agreement and not take any steps against the company, the company should not take any actions which would be detrimental to the prospective return to creditors.

The Fourth Principle
The interests of relevant creditors are best served by coordinating their response to a debtor in financial difficulty. Such co-ordination will be facilitated by the selection of one or more representative co-ordination committees and by the appointment of professional advisers to advise and assist such committees and, where appropriate, the relevant creditors participating in the process as a whole.

Points emphasized in the Commentary:
- Where justified by the number of creditors, co-ordination (steering) committees should be established.
- Co-ordination (steering) committees ensure that information is evenly disseminated to all creditors.
- The co-ordination (steering) committees can assist where financial creditors have conflicting interests.

The Fifth Principle
During the Standstill Period, the debtor should provide, and allow relevant creditors and/or their professional advisers reasonable and timely access to, all relevant information relating to its assets, liabilities, business and prospects, in order to enable proper valuation to be made of its financial position and any proposals to be made to relevant creditors.

Points emphasized in the Commentary:
- Debtor companies should provide a broad array of information to the creditors and their independent advisers (including accounts, projections, business plans, etc).
- The independent advisers should be allowed to conduct their own valuations.
• Any proposals should be made to relevant creditors.

**The Sixth Principle**
Proposals for resolving the financial difficulties of the debtor and, so far as practicable, arrangements between relevant creditors relating to any standstill should reflect applicable law and the relative positions of relevant creditors at the Standstill Commencement Date.

*Points emphasized in the Commentary:*
• The aim of the gathering and dissemination of information and due diligence during the Standstill Period is to provide creditors with the opportunity to evaluate the debtor’s position and to assess the debtor’s proposals with a view to ensuring that they are being treated the same as other similarly situated creditors.

**The Seventh Principle**
Information obtained for the purposes of the process concerning the assets, liabilities and business of the debtor and any proposals for resolving its difficulties should be made available to all relevant creditors and should, unless already publicly available, to be treated as confidential.

*Points emphasized in the Commentary:*
• It is essential that the creditors abide by confidential agreements.
• The rules neither favor nor prohibit debt trading.

**The Eighth Principle**
If additional funding is provided during the Standstill Period or under any rescue or restructuring proposals, the repayment of such additional funding should, so far as possible, be accorded priority status as compared to other indebtedness or claims of relevant creditors.

*Points emphasized in the Commentary:*
• New money can often be crucial to the overall success of the rescue in providing liquidity to the debtor.
• It will often be necessary to provide priority to creditors advancing new money.

In fact, the above recommendations of the principle are the sum-up of the practices that the countries make use of the approach of out-of-court workout to rescue the enterprises since the global financial turbulence in 1997. It is, of course, only the beginning. The countries still need to explore in a creative way according to their own situations and using the experience
of other countries for reference. There are close relationship between the rescue of the enterprises and the other special matters of China such as the particularity of the SOEs’ history, the undergoing fundamental change of the system, the strong function and the heavy duty of the government in the economic reform, the economic development, and the social security etc. All the above must not be neglected in the design of the system.

**Basic Framework of the System**

The trade process in the debt restructuring of enterprises is the process that the parties, the government and other social groups agree on the disposal of the distressed enterprises’ assets and debts and other matters, and perform the agreement. On the whole, there are two frames the process can apply to, which are civil law frame and bankrupt law frame.

The so-called civil law frame is made according to the rules of contract law, property law and other civil law, based on the equality, voluntariness and consensus of the parties to achieve the objectives of the rescue by the way of a series of trade in market such as the transfer of assets, concession of creditors, investment, financing, and commercial claim. The process called as “out-of-court workout” is in fact a kind of voluntarily multi-parties and treaty-making process. The initiator of the process (usually the debtor) has the freedom of choosing and inviting participants and the invitees have the freedom of acceding, quitting and bargaining. The agreement reached thereby only binds the signers of the parties. The advantages of the process are the simplicity, quickness, and low cost of trade. However, when there are many participants, due to lack of the established compulsory rules of process, they must negotiate and stipulate the matters on procedures before the negotiation on the specific trade terms of the restructuring arrangement. In the case of dissension, in spite of the majority vote, there is no way to refrain the dissenting parties from commencing lawsuit or other legal actions to resist it. Therefore, the operation of the procedures is very difficult if there are many participants and big divergence.

The so-called bankrupt law frame is using the mechanism of rescuing the enterprise, which is stipulated in the bankruptcy law. The mechanism of rescue stipulated in the current *Enterprise Bankruptcy Law* of China is
Chapter 4 “conciliation and rectification procedures”, which is a arrangement of system that unites the procedures of traditional conciliation and administrative rectification peculiar in China. 39 Since there is strong administration-arranged shade in the previous approach of rectification, creditors have little chance to participate in the procedure. However, the government is short of measures and resources to rescue and rectify the enterprises, and this procedure can only apply to few cases of creditor application. Therefore, the procedure is seldom applied in practice. But there are several merits peculiar to judicial conciliation procedure: firstly, it provides a way to avoid liquidation and termination of enterprise after individual creditor commences the proceedings of bankruptcy; secondly, individual recourse of all the creditors will be prevented and all the civil suits and enforcement will be frozen once the proceeding is commenced; thirdly, all the creditors can be compulsorily called together into the collective procedure presided over by the court; fourthly, all the creditors will be bound by the agreement of conciliation passed according to the majority vote; fifthly, the enterprise will gain a “standstill period” less than two years. Therefore, in the present frame of Chapter 4, it is possible for the procedure set aside for a long time to begin functioning as long as the government changes the previous administration-arranged approach, lets the creditor participants, enterprise debtor and social intermediary institutions play their roles, and explores the market resources actively, and meanwhile makes concrete rules to complement the procedure in the form of judicial interpretations.

39 Generally, the outline of the procedure is as follows:
——the commence of process depends on three conditions that: Firstly, the case is not applied by the debtor but by the creditor; secondly, during the three mouths after the acceptance of the case, the department in charge of the enterprise debtor presents the application of enterprise rectification to the court and creditors council (The period of rectification is no more than two years); thirdly, the enterprise debtor presents the draft of conciliation agreement to the creditors council after the presentation of the application of rectification.
——the draft becomes the effective agreement after the adoption of the creditors council and the approval of the court, and the proceeding of bankrupt shall be discontinued immediately.
——the enterprise debtor will be presided and rectified over by the department in charge. The scheme of rectification must be discussed by worker’s congress of the enterprise and the implementation should be reported to the worker’s congress and the creditor council.
——if the enterprise debtor is able to perform the conciliation agreement and pay the debts after the rectification, the bankrupt process should be terminated.
——if the enterprise debtor does not perform the conciliation agreement or the situation of its finance continues to deteriorate during the rectification, or is unable to pay the debts according to the conciliation agreement at the expiration of the rectification, the court should declare the bankruptcy of the enterprise.
Since there are different merits in each system frame, which frame will be applied in practice will depend on the specific situation of individual cases. Moreover, the two procedures can also be used together in the application to the same case. For example, when individual creditor commences a lawsuit, enforcement or bankruptcy proceeding in the restructuring according to the civil law frame, the bankruptcy law frame can be applied to agree on the restructuring arrangement as the scheme of conciliation and rectification in light of judicial process and to implement it. Similarly, the participants can commence the bankruptcy proceeding first, then work out of court actively and put the agreed terms of restructuring trade into the scheme of conciliation and rectification so that it can be brought into judicial procedure. In addition, the creditors without participating in the restructuring negotiation, according to the civil law frame, can also force the restructuring negotiation to be the collective process according to the bankruptcy law frame by the way of applying for debtor’s bankruptcy, and thereby the debt restructuring of enterprises based on the equal participation will be achieved.

**Proposals for Enacting Administrative Regulations, Judicial Interpretation, and Taking Relative Measures**

**A. Proposing the State Council Issue “Several Provisions on Disposition of Assets in the Debt Restructuring of Distressed Enterprises”**.

The legal foundation for this regulation is that, as the representative of the state owner, the State Council has the right to dispose the state-owned assets. The main task of this regulation is to define the bounds of basic policies and the rules of operation in enterprise debt restructuring, which chiefly includes the following:

1. **Objectives and primary principles of enterprise debt restructuring.** The objectives are to preserve the value of assets, to maintain the security of finance, to maintain the employment of workers, and to achieve the payment for debts. The primary principles are the principle of market circulation, the principle of fair repayment, the principle of workers protection and the principle of legal trade.

2. **Range of distressed enterprises.** The distressed enterprises covered in this regulation should meet the following qualifications: (1) solely
state-owned enterprises;\textsuperscript{40} (2) enterprises that are highly indebted, unable to pay for the due debts, no bank credit, but have assets with the certain operation ability and profit making capacity.

3. *Administrative institution on enterprise debt restructuring.* Special administrative organizations or institutions concerning debt restructuring of enterprises shall be set up by the municipal governments above, which is in charge of the examination and approval, guidance, coordination, and supervision of the enterprise restructuring.

4. *Application and approval.* The application shall be made by at least one creditor, including the primary bank creditor, together with the enterprise debtor to an administrative agency of enterprise debt restructuring. The enterprise shall fill in the form of application, and submit the recent yearly, quarterly and monthly financial report, and information about the enterprise’s finance and business, and recommendation of the enterprise restructuring scheme. The primary bank creditor shall submit the valuation on the situation of the enterprise’s assets and credit, and the valuation on the recommendation of the enterprise-restructuring scheme. The administrative agency of enterprise debt restructuring shall do something such as necessary investigation, consultation and proof after the receipt of the application.

5. *Creditor convention and creditor committee.* The approved enterprise shall choose the date and the place of the creditor convention and inform all creditors known fifteen days before the date of the creditor convention. The creditor convention will be presided by the person in charge of the enterprise. The person in charge of the enterprise shall circulate a notice of the situation of the enterprise’s finance and business at the convention, present the recommendation of the enterprise’s debt restructuring and give a necessary statement, and answer the questions of creditors. Creditors have the right to express their opinions. The resolution of the convention is decided by a simple majority vote. The resolution shall bind all the members who attend the creditor convention except the creditors who declare to quit. The creditors who are absent or declare to quit can attend the creditor convention with declaration later. If

\textsuperscript{40} They include the registered enterprises according to the *Company Law* and the *Law of State-owned Industrial Enterprises*. In addition, it is also stipulated in the supplement that if decided by the highest power of the enterprises, other enterprises out of the sphere of this regulation may refer to this regulation to carry out debt restructuring.
the convention agrees on the restructuring, a committee comprised of the representatives of creditors shall be set up, which will negotiate with the enterprise debtor and draw up the scheme of the restructuring. The scheme will be decided by the majority vote after the individual creditor expresses their own opinions on the scheme. Once the scheme is passed by, the committee automatically gets the agent power and is in charge of the further matters of the restructuring trade according to the related rules of the agency system of the civil law.

6. *Outside financial advisor.* We suggest that during the restructuring the primary bank creditor appoint one or two financial advisors from banks or intermediary institutions, who will assist the enterprise to analyze the finance of the enterprise and draw up the scheme of the restructuring. The cost of the financial advisor will be paid by the enterprise.

7. *Valuation of assets and appraisal of claims.* The claims to be traded at a discount and the assets to be disposed of in the enterprise’s restructuring must be evaluated by legal valuation institutions. All the creditors should be informed of the result of the valuation. If the valuation involves the state-owned assets and claims, the result of the valuation should be reported to the state-owned assets management department for examination, approval, and confirmation.

8. *Assets transfer and debts repayment.* In the enterprises’ debt restructuring, the third party can purchase the profitable assets with the loans from the bank and the money paid will be partly or wholly repaid for the enterprise’s debts owed to the bank. The Financial Assets Management Company (FAMC) can sell at a discount to a third party the claims to the enterprise, and the third party will use the purchased claims to offset the money paid for purchasing the enterprise’s profitable assets. The enterprise can use the enterprise’s discounted assets to pay for the deferred wages, retirement pension, social insurance funds, medical expenses, and a lump-sum compensation for giving up the status of the SOE’s workers, and all these assets shall be transferred as collective investment to the third party together with the enterprise’s tangible assets, which then become the workers’ equity in the enterprise of the third party. The enterprise can also use the current value of the enterprise’s assets to exchange the cash value of the claim of creditors which is figured out in accordance with the liquidation value, and then the enterprise transfers the assets to the third party equivalent to the exchange value, and thereby
the creditor gets the corresponding equity in the enterprise of the third party. The transfer of the property and the registration of the equity shall be handled according to the relevant laws and regulations.

9. **Transfer of the enterprise’s assets.** Any enterprise can be the transferee of the enterprise’s assets. Local government can invest specially for the restructuring to form a new company in charge of the transfer of the enterprise’s assets. The form of the investment may be in capital or the right of using the state-owned land, which the debtor enterprise got by allocation.

10. **Security of increased financing.** The financing for the assets transaction of the enterprise’s debt restructuring can be secured on the assets of the transferor or the transferee.

11. **Merger and joint venture.** The assets of the debtor enterprise can be handled by means of merger and joint venture.

12. **The settlement of the workers.** If the assets of the enterprise are completely transferred to the third party in debt restructuring, the third party should employ the workers of the creditor enterprise first according to the requirement of the operation of the assets.

13. **Lease of the assets.** The debtor enterprise can dispose the assets that had not been disposed in the restructuring, such as selling off, and lease, etc.

14. **Supervision and punishment.** To avoid the waste of the state-owned assets, dodge of the bank debts, and other acts that violate the repayment procedures, it is necessary to make the necessary supervising measures and punishment.

**B. Proposing the Relevant Department of the Government Enact Relevant Regulations**

To coordinate the implementation of the above-mentioned documents of the State Council and resolve the relevant specific problems in enterprise debt restructuring, we suggest that the relevant departments of the Central Government enact the following regulations on the basis of strengthening their coordination.

- **Opinions on Some Issues Concerning Financial Institutions Participating in Debt Restructuring of Enterprises by the People’s Bank of China.** According to the relevant provisions on the transfer of the assets and repayment to the debts in the above mentioned
document, specific stipulations shall be enacted on the negotiation, examination and approval, setting security, accepting repayment, and relevant accounting affairs of the financial institution creditors and the assets management corporation in the debt restructuring, which occur in loaning, selling claims, debt-equity swap trade.

- **Provisions on Valuation of Assets and Claims in Debt Restructuring of Enterprises by the State Economy and Trade Commission and the Ministry of Finance.** According to the relevant stipulations concerning the valuation of the assets and claims in the above mentioned document of the State Council, detailed implementing regulations shall be enacted on the valuation institution, procedure, method, supervision, and the announcement of the valuation result, etc.

- **Regulations on the Problems of Transfer and Allocation of Assets in the Enterprise Debt Restructuring by the State Economy and Trade Commission, the Ministry of State Land and Resources, and the Ministry of Construction.** This document gives detailed regulations on the relevant problems of transfer and appropriation of the land, building, equipment, and transportation tools in the debt restructuring of enterprise.

- **Detailed Opinions on the Reconciliation and Restructuring of Bankruptcy Enterprise by the State Commission of Economy and Trade.** To play a supporting role in the debt restructuring of enterprise and carry out Chapter 4 of the Enterprise Bankruptcy Law on the reconciliation and restructuring, the government puts forward a series of detailed projects to mobilize each side to realize the rescue of enterprises. The proposal states that the management agency of enterprise restructuring of the local government appoints a restructuring group, composed of the manager of the enterprise, the representatives of the creditors, the intermediary institution, and the officials of the government. The group is responsible for the disposal of the assets of the enterprise and clearing up the claims during the restructuring, according to the methods in the above mentioned document of the State Council.

C. Suggesting the Supreme Court Issue Relevant Judicial Explanations
For the implementation of the above documents issued by the State Council, we suggest the Supreme People’s court enact some relevant judicial explanations regarding the problems in the application of the relevant laws.

At first, we suggest enacting *Opinions on the Application of the Reconciliation and Restructuring of Enterprise Bankruptcy Law of the Peoples' Republic of China in the Debt Restructuring of Distressed Enterprise.*

To coordinate the implementation of the mentioned documents and guarantee the debt restructuring carried out smoothly, when individual creditor sues, applies for execution, or applies for bankruptcy, we suggest the supreme court enact a series of operation regulations suitable for the restructuring of the enterprise, based on Chapter 4 of the *Bankruptcy Law* of China. The most important points are as follows:

1. During the restructuring, the lawsuit proceedings and the civil execution proceedings should be stopped, terminated, transferred or refused based on different situations, in accordance with Article 11 of the *Bankruptcy Law* and Articles 12, 13, 14, 17 of the *Opinions of the Supreme People’s Court on the Implementation of the PRC Enterprise Bankruptcy Law*.

2. As stipulated in Articles 17 to 20 of the *Enterprise Bankruptcy Law*, the authority department of higher level may be the authority management institution in charge of the state-owned enterprises’ bankruptcy and restructuring. The institution may appoint the manager of the enterprise, the representative of the creditors, the intermediary institution, and the government officials to form a group, which is responsible for the disposal of the assets and clearing up the claims.

3. The restructuring group may put forward the proposal of disposal of the assets of the bankruptcy enterprise and clearing up the claims. The proposal should be submitted to the workers' congress and the creditors meeting for discussion and approval respectively.

4. After the scheme of the disposal of the assets and debts repayment of the bankruptcy enterprise has been approved, under different situations, in accordance with the provisions in Article 21 or 22 of *Enterprise Bankruptcy Law*, the procedure of declaration of bankruptcy or that of termination of bankruptcy shall be applied.
Secondly, in the making of judicial explanations of the Trust Law, the Security Law and the Contract Law, the relevant regulations on assets trust, claim trust, security of new loans involved in the restructuring, and restructuring agreement, etc., shall be enacted.

D. Carrying out Corresponding Measures to Guarantee the Implementation of the Above Administrative Regulations and Judicial Explanations.

With the implementation of the above regulations and carrying out the restructuring in a large scale, it is an urgent and important task to train officials, enterprise manager, clerks of the bank and social intermediary institutions. Moreover, letting more people pay attention to debt restructuring and be aware of it can bring about positive effects.

Training program. In order to help the trained people to systematically grasp the knowledge about the law, policy, accounting and practical experiences regarding the debt restructuring, we suggest the State Commission of the Economy and Trade and other departments make a three-year training plan with the assistance of the international organization. We can choose some of the early-trained persons as the teachers for the later training. The training can also gain the assistance of specialists from abroad.

Operation guidance and compilation of cases. To make more people go in for the debt-restructuring program now or in the future, coordinate, or assist in the work, we suggest compiling a set of books as operation guidance on the debt restructuring of enterprises. At the same time, collect, sort out some typical cases and compile Selected Cases of the Debt Restructuring of Enterprises in China, then get it published so that people can better understand it, discuss it, and put forward suggestions for improvement. Operation Guidance and Selected Cases Compilation can be used as teaching materials or references for the above-mentioned training courses. The colleges and universities that satisfy the requirements can compile the textbooks on the basis of these materials, and offer a course.

Suggestions on Enacting Relevant Laws
A. Promulgating a New Enterprise Bankruptcy and Restructuring Law

China has begun to enact the new bankruptcy law. The new bankruptcy law will make use of the experiences of the most new international study achievements for reference, and establish the restructuring system. The design of the restructuring system in the draft will lay stress on the following points:

- The restructuring may start when the enterprise is in distress but before falling into insolvency. The debtor, creditors, and investors have the right to petition for restructuring.
- During the restructuring, the enterprise continues operating under the management by the administrator appointed by the court. The administrator can appoint the manager of the enterprise to take charge of the business.
- Establishing a multiple consulting system including the debtor, creditor, investor, and workers. The restructuring plan should be a synthetically revival project of the enterprise, including debt restructuring, enterprise restructuring, staff reduction, and title transfer, etc.
- When the legal requirements are satisfied, in spite of disagreement from some creditors, the court may enforce the restructuring anyway.

The new bankruptcy law will also establish a reconciliatory process convenient for the parties to reach an agreement quickly. One provision of the draft stipulates that the debtor may reach an out-of-court agreement with all the creditors voluntarily in the bankruptcy proceedings, so as to terminate the bankruptcy procedure. The new bankruptcy law draft will also improve the liquidation procedures, and strengthen the sanction to illegal conducts of dodging the debts.

The draft of new bankruptcy law is highly appraised domestically and abroad. From 2000, the draft of new bankruptcy law has officially adopted the name of the Enterprise Bankruptcy and Restructuring Law of the People’s Republic of China, and has been further amended. It is believed that the promulgation of the new bankruptcy law early will establish a normative bankruptcy order and an active judicial mechanism for business restructuring meeting the requirements of the market economy and consistent with
Moreover, the promulgation of the new bankruptcy law will also provide a good system environment and legal protection for effective out-of-court debt restructuring, just as the experts at the UNCITRAL Working Group on Insolvency Law pointed out: "[T]he strongest incentive to engage in such out-of-court negotiations was the imminence, effectiveness and credibility of proceedings to enforce private claims and securities and of involuntary, formal, court supervised insolvency proceedings and the desire of both debtor and creditors to avoid the disruptive and stringent consequences of those proceedings. When such court proceedings were not credible or effective (e.g. because of court delays or because they did not ensure equitable treatment of creditors), the debtor might not be willing to engage in out-of-court negotiations. Even the prospect of fresh financing linked to an informally negotiated solution might not be sufficient incentive for the debtor inasmuch as ineffective court proceedings allowed the debtor to delay having to meet its obligations. Furthermore, experience had shown that leverage was needed over some creditors who might hold out for full satisfaction of their claims."

B. Studying Actively and Enacting Distressed Enterprise Restructuring Law at Proper Time

As to the legislation regarding the distressed enterprise restructuring, it is a popular international issue discussed heatedly. In the 22nd meeting of the bankruptcy law group of the United Nations Commission of the International Trade in December 1999, there was a discussion on this issue. "Reservations were expressed regarding the proposition of elaborating a mandatory legislative mechanism designed to promote out-of-court procedures. It was said that the informal process of out-of-court negotiations might be disturbed by the formality of the proposed mechanism. It was also said that the proposal was likely to encounter opposition, in particular in the banking community, and that therefore any further work should be preceded by

41 United Nations Commission on International Trade Law Working Group on Insolvency Law
consultations with the banking community. Furthermore, any such legislative concept might have to be tailored to conditions in various regions and, therefore, universal solutions were difficult to obtain.” “However, opinions were also expressed that, while realizing potential difficulties and pitfalls involved in a mandatory legislative framework for out-of-court procedures, the proposal should not be abandoned because a well thought out mechanism might offer significant benefits. It was added that if the role of the court in informal negotiations was limited to the approval of the fairness of the outcome, that might be widely acceptable and would not be overly intrusive. As an alternative, it was envisaged that the out-of-court procedure might include a non-judicial forum that would be empowered, by agreement of the parties, to evaluate whether the arrangement negotiated between the debtor and the majority of creditors was fair and, if it was found to be fair, to bind the minority of non-consenting creditors.”

As to legislation concerning debt restructuring of enterprises, there are some precedents abroad. For example, France promulgated No.94-475 Act in June 1994, that is, Prevention et traitement des difficultes des entreprises. This Act adopted and modified the conciliation and liquidation system abolished in 1985 based on the previous experience, and strengthened the treatment for the enterprise’s distress in the early stage. This Act also made some amendments to Judicial Restructuring and Liquidation for Distressed Enterprises promulgated in 1995 to strengthen the protection for creditors. Since promulgation, this Act is welcomed by judges, lawyers, and entrepreneurs, and it is applied widely in practice. The main points of the debt reconciliatory processes are as follows:

● **Special agent.** According to Article 4 of the Act, although it has not stopped payment, the enterprise is faced with judicial, economic, and financial difficulties, or its payment capacity can not satisfy its needs, the representative of the enterprise can apply to the chief of the commercial court for the reconciliation. The representative should explain the situations of the enterprise’s finance, economy, social affairs and financial requirement, and the measures to resolve these problems as well in the application. The chief of the commercial court has right to appoint a special agent (mnadataire ad hoc) to mediate and assist the

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42 Ibid., para. 111, 112, p.5.
parties to find a way that is in conformity with the interests of each party to resolve the problems.

- Reconciler. When the special agent fails in the reconciliation, the chief of the commercial court can appoint a reconciler, or appoint a reconciler directly instead of appointing a special agent after receiving the reconciliation application from the representative of the enterprise. The Act stipulates that the reconciler is in office for three months, and if the reconciler requires, the term for his post can be extended for no more than one month. In practice, the term of the reconciler’s office is normally four months. The commercial court shall decide the work of the reconciler. The task of the reconciler is to promote the operation of the enterprise and seek an agreement with creditors. The chief of the commercial court shall inform the reconciler about the information that he has and report to experts when necessary.

- Temporary suspension order. If the reconciler thinks it is necessary to temporarily suspend the resource right of the creditors to reach a reconciliation, he may apply to the chief of the commercial court for an order. After hearing the opinions of the primary creditors, the chief of the commercial court can issue a temporary suspension order. The period for the temporary suspension order shall not be longer than the term of the reconciler’s office. The temporary suspension order makes the proceedings of resource to the debts temporally suspend, and meanwhile, forbids the creditors to do the following acts during the temporary suspension period:
  - Demanding the debtor to repay the debts;
  - Canceling the contract for the reason of non-payment to the debts;
  - Demanding a compulsory execution of the chattel and real estate.
  - The above regulation applies to the secured creditors. The guarantor shall not dispose the mortgage and pledge. However, the above regulation is not applied to the debts originated from labor contracts.

- Reconciliatory agreement. The reconciliatory agreement reached with the creditors must get the approval of the chief of the commercial court and be registered. If the reconciliatory agreement is reached with the primary creditors, the chief of the commercial bank can also grant his approval, and at the same time, he can permit the debtor to extend the term to repay the debts not included in the agreement according to Article 1244, Section 2 of the Civil Code. During the performance of the
agreement, all the judicial action and resource action that aim to the chattel or real assets of the debtor for the purpose of repaying the debts shall be suspended. As a result, the limitation of action of the creditors is suspended. The reconciliatory agreement has civil contract effects. Nevertheless, this Act provides that the court shall declare to revoke the reconciliatory agreement and the payment term agreed in the agreement becomes invalid if it is not complied by the parties.

In addition, there is much in the experiences of other countries introduced in Part III of this report that we can make use of. We need to combine the experiences with China’s reality when we adopt and use them. Moreover, while we are studying the experience abroad, we should also attach great importance to our own practical experience to summarize them theoretically. We believe, based on the practical experience and theoretical summary of our country, we can make the above mentioned administrative regulations and judicial explanations, and then after several years’ research and perfection, we will come up with a relative complete and mature system concerning debt restructuring of SOEs. On this basis, we are sure that we can enact an enterprise restructuring law with characteristics of China and valued internationally.