

Current Status of Insolvency Law Reform Efforts in China *

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Introduction

Much international attention has focused on those jurisdictions that reformed their corporate insolvency laws after the onset of the Asian financial crisis. A second wave (if it can be called that) of reform is now underway. The ongoing insolvency law reform efforts of the People's Republic of China (the "PRC" or "China") fall within this category and are the focus of this paper.

The PRC is in the midst of developing its institutional frameworks for assisting with the transition from a centrally planned economy to a more market-based economy. An integral part of this development was the enactment of an insolvency law in 1986 – the Law of the People's

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Republic of China on Enterprise Bankruptcy (Trial Implementation) (the "1986 Chinese Bankruptcy Law").¹ This law has not proven to be overly effective, and the number of insolvency cases in China remains relatively low, ranging from a low of 32 in 1990 to 8,939 in 2001.²

2

The Chinese government initiated a review of the Chinese bankruptcy law in 1994, and a first draft bankruptcy law was completed in 1995. After a hiatus, the drafting process resumed in 1998. Further drafts of the law were released in 2001 and, more recently, in 2002 (the "2002 Draft Chinese Bankruptcy Law"). The current draft contains 162 articles. It is anticipated that a further draft will be released later in 2004 or early in 2005.

Concurrently with the work on the draft formal bankruptcy law, China has also taken steps to formulate out-of-court rehabilitation mechanisms. Four asset management companies have been established to deal with non-performing loans, and the Chinese State Economy and Trade Commission devised procedures for the out-of-court restructuring of state-owned enterprises ("SOEs").³

Of course, there are serious impediments to fast-tracking insolvency law reform in China and dramatically increasing the number

¹ Law of the People's Republic of China on Enterprise Bankruptcy (Trial Implementation), Standing Committee of the National People's Congress, Dec. 2, 1986. For an English translation, see General Office of the Legal Commission under the Standing Committee of the National People's Congress (compilation), LAWS OF THE PEOPLE'S REPUBLIC OF CHINA (CIVIL AND COMMERCIAL LAWS) 684-95 (1998). The 1986 law is applicable to state-owned enterprises ("SOEs"). Other national insolvency legislation, applicable to non-SOEs, is included in Chapter 8 of the PRC Company Law of 1993 (for corporations formed under the Company Law) and Chapter 19 of the PRC Civil Procedure Law (for other enterprises, including foreign investment enterprises). Other local insolvency procedures have also developed in China, e.g. in Shenzhen; see Xianchu Zhang & Charles D. Booth, *Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience*, 15 COLUM. J. ASIAN L. 1 (2001).

² According to the statistics collected by the Beijing Siyuan Merger and Bankruptcy Consultancy. Cao Siyuan, *Implementation and Revision of the Bankruptcy System in China*, a paper presented at INSOL China 2002, held in Beijing, China, Oct. 9-11, 2002.). The annual levels are as follows: 1989 – 98; 1990 – 32; 1991 – 117; 1992 – 428; 1993 – 710; 1994 – 1,625; 1995 – 2344; 1996 – 6,233; 1997 – 4,515; 1998 – 6,148; 1999 – 4,591; 2000 – 7,528; and 2001 – 8,939.

³ See Wang Weiguo & Charles D. Booth, *Study on Alternative Approaches for Debt Restructuring of Enterprises in China*, World Bank Report for the State Economy and Trade Commission of China (2002).

of liquidations – namely, the adverse effect on workers (which could lead to social unrest) and on the State banks (which are in the process of dealing with their high levels of bad debts).

Scope of the Law

The 2002 Draft Chinese Bankruptcy Law has its origins in an attempt to address the problems related to SOEs. Nevertheless, the draft law exempts most SOEs from the new law. Article 3 of the 2002 draft states that the State Council is authorized to stipulate regulations concerning the special issues of bankruptcies conducted by SOEs that were established before 1994, when the Company Law of the People's Republic of China took effect. Although the issue has not been conclusively resolved, it appears that the older, larger, more inefficient SOEs will be exempt from the application of the new law. It has not yet been resolved as to what law or regulations will apply to these exempted SOEs. The current 2002 draft law provides that when the new law comes into operation, the 1986 Chinese Bankruptcy Law will be abolished,⁴ but this issue is also still being debated.

Other notable exclusions from the draft Chinese law are commercial banks⁵ and consumers. The scope of the exemption for banks is still under consideration and it is possible that the exemption will be expanded to other types of financial institutions and insurance companies. As with SOEs, it is unclear at this stage what legal regime will apply to banks and consumers.

Subject to these exemptions, the 2002 Draft Chinese Bankruptcy Law will extend to a broad array of business-related entities: SOEs not otherwise exempt, enterprise legal entities, partnership enterprises and their partners, sole proprietorship enterprises, and other profit-making organizations that are established in accordance with the law.⁶ The latest draft thus departs from the old focus on SOEs in the 1986 law to encompass a wider spectrum of subjects.

⁴ 2002 Draft Chinese Bankruptcy Law, art. 162.

⁵ *Id.*, art. 160.

⁶ *Id.*, art. 3.

Corporate Rehabilitation

A major impetus for the enactment of new insolvency laws in China is to facilitate corporate rescue, rather than liquidation, which at present is the norm. In the 2002 Draft Chinese Bankruptcy Law, chapter VI provides for reorganization of enterprises and chapter VII, for conciliation of other debtors. The Chinese corporate rescue provisions are more comprehensive than the existing provisions in the 1986 Chinese Bankruptcy Law, but the relevant provisions in the draft law still need to be expanded.

Commencement

The 2002 Chinese Draft Bankruptcy Law provides for a 3-step process whereby:

1. A petition is filed.
2. The court makes a determination whether to accept or handle the case. This “gap” period should not last longer than fifteen days.⁷
3. The court decides whether to order the debtor to be declared bankrupt or to be rehabilitated.

The automatic “stay” on unsecured creditors does not come into effect until the date of acceptance⁸ and the draft does not provide for a remedy to prevent dissipation of the debtor’s assets if the court does not make a timely order.

The 2002 draft law does not require the petitioner to specify the relief sought at the time of petitioning, and, where relief is not requested, certain parties are permitted to make a request after the court accepts the case, but before the declaration of bankruptcy. Article 11 of the 2002 draft law provides that either the debtor or the creditors may file an application for bankruptcy with the People’s Court if a debtor is unable to pay off the debts when due. Article 4 provides that a debtor is presumed to be unable to pay its debts if it ceases to pay them off. However, the article fails to define what is meant by “cessation of payment” or what type of evidence

⁷ *Id.*, art. 14, although there is no mechanism for forcing compliance with the fifteen-day requirement.

⁸ *Id.*, arts. 19, 20, and 120. Articles 68 and 71 extend the stay to secured creditors upon the ruling by the People’s Court for the debtor to reorganize.

of the cessation must be produced. No particular time limit is expressly required and no minimum level for the debt is set forth; however, the legislation sets out further requirements including that the applicant must include, amongst other things, the reasons and grounds for the application and other matters that the People's Court thinks should be contained.⁹

Article 66 of the draft Chinese law provides that either the debtor or the creditors may apply for reorganization at the time of petitioning or after the court accepts the case, but before the court declares the debtor bankrupt. Although shareholders are not permitted under the draft Chinese law to file a petition, article 66 permits them to apply for reorganization after the court accepts the case, but prior to the declaration of bankruptcy, so long as more than a third of the shareholders support the application. The conciliation procedures are more limited: article 95 provides only that the debtor may apply for conciliation either at the time of petitioning or after acceptance, but prior to the declaration of the bankruptcy case.

Under article 19 of the Chinese draft law, once the People's Court accepts the bankruptcy case, any measures to preserve or otherwise execute on the debtor's property are suspended unless otherwise provided under the draft law. Similarly, pursuant to article 20, ongoing civil litigation concerning the property and property rights of the debtor is suspended until the administrator takes over the debtor's property. Article 20 further provides, confusingly, that after the administrator takes over the debtor's property, the litigation shall continue. Pursuant to article 22, payment by the debtor to a specific creditor will be invalid after the People's Court accepts the case. In addition, pursuant to articles 68 and 71, secured creditors are stayed during the "protective period of reorganization" – from the date the court makes a ruling for the debtor to reorganize to the date that the court approves the reorganization plan or terminates the reorganization.¹⁰

⁹ *Id.*, art. 12.

¹⁰ However, art. 71 of the 2002 Draft Chinese Bankruptcy Law also permits secured creditors to apply for relief from the stay. Secured creditors are not bound by the stay in bankruptcy or conciliation. See *id.*, arts. 119-121.

Insolvency Officials

Under the draft Chinese law, the various functionalities include an administrator,¹¹ the creditors' meeting,¹² the chairman of the creditors' meeting,¹³ up to three supervisors (to be chosen by the creditors' meeting),¹⁴ the reorganization executor,¹⁵ and the court. Article 16 requires the People's Court to designate an administrator when accepting an application for bankruptcy. Article 25 authorizes the administrator to take over all of the debtor's property as from the date of appointment by the People's Court. In addition to exercising the general administrative functions set out in article 29 of the draft law (which includes taking control of the debtor's property), the administrator also takes over the daily management of the debtor's property and business affairs.¹⁶

The Chinese administrative structure includes many checks and balances, but the overall result is that ultimately many of the functions are not clearly demarcated. For example, article 28 provides that the administrator "shall be responsible for and report his work to the People's Court", as well as that the "performance of the functions by the administrator shall be supervised by the creditors' meeting". The same article also provides that the administrator shall attend the creditors' meeting as a non-voting delegate and report on the performance of his functions. Moreover, pursuant to articles 63 and 64, the administrator must also report to the supervisor(s), and the supervisor(s) is/are given certain supervisory powers over the administrator, including seeking rulings by the People's Court where an administrator violates the draft bankruptcy law and refuses to accept supervision. Ultimately, the variety of functionalities with supervisory powers over the administrator may make it difficult for the administrator to efficiently perform his responsibilities.

¹¹ See *id.*, arts. 27 to 32.

¹² See *id.*, arts. 54 to 61.

¹³ See *id.*, art. 55. The chairman is selected by the creditors' meeting (from among the creditors with a right to vote) and designated by the People's Court and presides over the creditors' meeting.

¹⁴ See *id.*, arts. 62 to 64.

¹⁵ See *id.*, arts. 90 and 92.

¹⁶ See *id.*, art. 28.

Distribution of Assets and Protection of Employees' Interests

The draft law provides for the basic elements of asset preservation, collection and distribution. The order of payments is roughly as follows: (1) costs and expenses relating to the bankruptcy case and certain debts incurred after the acceptance of the case, called "debts of common benefit"¹⁷; (2) wages of employees, social insurance and other relevant debts as provided under labor law; (3) tax liabilities; and (4) general unsecured bankruptcy claims.¹⁸

The emphasis on the protection of employees' interests is clear:

- a) Priority of payments to workers is ranked second only to the basic costs and expenses of the bankruptcy.
- b) The draft explicitly provides that the People's Court is to safeguard the lawful rights and interests of the employees of bankrupt enterprises in accordance with the law, and that the people's government of the place where the bankrupt enterprise is located is to arrange the settlement and lifetime guarantee of the employees' rights.¹⁹

Avoidance Powers

The 2002 draft includes provisions to avoid unfair transactions entered into by the debtor to the prejudice of general creditors. Pursuant to article 33, the administrator is entitled to request that the People's Court rescind the following actions taken by the debtor within one year of the People's Court acceptance of the bankruptcy case:

- a) Transferring property or property rights free of charge.
- b) Transferring property at an obviously unreasonably low price.
- c) Providing property security for an existing unsecured debt.
- d) Paying off in advance a debt that is not due.

¹⁷ Which are defined in *id.*, art. 40.

¹⁸ See *id.*, art. 135.

¹⁹ *Id.*, art. 10.

- e) Giving up credits.
- f) Engaging in other activities that impair the interests of the creditors.

8

Further, pursuant to article 34, the administrator is entitled to attack payments made by the debtor within six months of acceptance where the debtor, with full knowledge of his inability to pay off his due debts, pays off debts to specific creditors and impairs the interests of the other creditors.²⁰

Lastly, pursuant to article 35 gives there is no time limit for recovery where the debtor is hiding or illegally distributing property, or if the debtor is fabricating debts or recognizing fictional debts.

These proposed provisions are inadequate and require further supplementation and greater detail. More precise distinctions should be drawn between preferences (i.e., unfair preferences) and fraudulent conveyances or transactions at an undervalue. In addition, it would be administratively easier to use the date of the petition as the relevant date, rather than the date on which the People's Court accepts the case. Furthermore, the revised provisions should answer the following questions:

- a) Who has the burden of proof and what must be proven under each cause of action?
- b) What are the appropriate defenses?
- c) For which powers is it necessary to prove that the debtor was insolvent at the time of the relevant transaction? Is insolvency ever presumed?

Finally, longer recovery periods should be available in transactions involving insiders, associates, or connected individuals.

²⁰ Article 34 includes an exception where the specific repayment benefits the bankrupt's property.

Cross-Border Insolvency Issues

Article 8 of the 2002 Draft Chinese Bankruptcy Law explicitly provides that the draft law applies to a debtor's assets outside the PRC. However, in regard to in-bound transactions, article 8 is not as clearly universal.⁹ Rather, it provides that when, in the course of the foreign bankruptcy procedures, a foreign party applies for execution on the debtor's property located in the PRC, the People's Court *may* make a ruling of approval, except in the following cases:

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

The discretionary nature of the fourth factor will quite likely lead to uncertainty as to whether a ruling of approval will be made. Nevertheless, article 8 improves upon the current situation; the 1986 Chinese Bankruptcy Law does not include any provisions regarding cross-border insolvency. Moreover, the inclusion of this provision would signify a more flexible approach than the "territorial" position traditionally adopted by the PRC towards foreign bankruptcies.²¹

It would be helpful if China gave thought to enacting provisions based on the UNCITRAL model law on cross-border insolvency.

Conclusion

Chinese insolvency law has come a long way since the enactment of the 1986 Chinese Bankruptcy Law, and the 2002 Draft Chinese Bankruptcy Law is an important part of the ongoing efforts to create an effective insolvency law regime. There is no doubt that the 2002 draft is much

²¹ For a discussion of the PRC's application of the territorial approach, *see* Zhang & Booth, *supra* note 1, at 24-26.

more comprehensive than the existing 1986 law, with a greater focus on corporate rescue. However, the latest draft would benefit from a resolution of the important question regarding the application of the proposed draft law to SOEs. The draft would also benefit from the inclusion of more detailed provisions. 10

It had been hoped that China would enact its new insolvency law sometime in 2005. But with a further draft of the law to be distributed in late 2004 or early 2005, it is likely that enactment will occur until 2006 at the earliest. Once the draft law comes into operation, it will then only be a matter of time until pressure builds for China to consider enacting a consumer bankruptcy law.