

# CHINA'S NEW CORPORATE RESCUE LAWS, PERSPECTIVES AND PRINCIPLES

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*This article considers the new corporate insolvency legislation that came into force in China in June 2007. This law is part of a remarkable transformation in the Chinese economy in recent years. Significant numbers of ailing state owned enterprises have been reformed and subjected to hard budgetary constraints, while the private sector has grown dramatically. Market forces play a greater role, whereas the economy was previously tightly controlled by the state. These changes, together with pressures arising from external bodies such as the European Union, led to an urgent need for the adoption of the revised insolvency law, which has at its heart corporate rescue procedures. This article considers the content of this new law, the background to it, and also assesses the prospects for its operation. In particular attention is paid to the level of scope for state interference in the operation of the law.*

Keywords – Chinese law – state owned enterprises – corporate rescue – state interference

## A. INTRODUCTION

For almost thirty years China has been on a long road of reform, casting off features of its planned economy in the development of a market economy. This reform process has escalated in recent years, with the requirements associated with accession to the WTO, and a number of key developments have taken place, including a reduction in state interference in the market; reforms to corporate

governance;<sup>1</sup> and the liberalisation of the banking regime.<sup>2</sup> One particularly notable aspect of state interference related to the treatment of uneconomic state owned enterprises which had emerged under the planned economy and could not be easily liquidated on account of their key social role. Although insolvency laws were available,<sup>3</sup> their use could be blocked by the state and there was an exemption that could be applied to many SOEs (State Owned Enterprises).<sup>4</sup> The preference was

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□ S Tenev, C Zhang and L Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (Washington DC, World Bank and International Finance Corporation, 2002).

<sup>2</sup> For a recent review see S Thomas and C Ji, "Banking on Reform" (2006) 33 (3) *China Business Review* 20. On earlier reforms see YK Mo, "A review of recent banking reforms in China" in *Bank for International Settlements Policy Papers No. 7 - Strengthening the Banking System in China: Issues and Experience*, 90.

<sup>3</sup> Enterprise Bankruptcy Law (for Trial Implementation) 1986, hereafter the "1986 Law".

<sup>4</sup> 1986 Law, Articles 3 and 8.

for planned bankruptcies under the control of the government. The beginning of the end of this particular phase of state interference has recently been marked with the introduction of a revised system of insolvency laws, which took effect on June 1st 2007.<sup>5</sup> The new law prima facie marks a transition to court-centred, market driven, bankruptcies free from state control. Potentially this reform could have a huge impact in contributing to the development of the socialist market economy, through enabling liquidations that would not have taken place previously and, more positively, through the implementation of formal corporate rescue procedures. However the full potential of the new law is unlikely to be reached in the short term. If the law operates entirely according to market forces it could potentially have a devastating social impact in view of the role played by SOEs in providing financial benefits to employees and the lack of an adequate social welfare system to fulfil this role in the absence of the SOEs.<sup>6</sup> For this reason a level of state interference is likely to persist and the manner in which the new law is drafted and is to be operated should facilitate this to a limited extent.

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<sup>5</sup> The Enterprise Bankruptcy Law of the People's Republic of China, hereafter the "2006 Law".

An unofficial English language translation of the new law is available at

<http://www.lehmanlaw.com/resource-centre/laws-and-regulations/company/the-enterprise-bankruptcy-law-of-the-peoples-republic-of-china.html> accessed 29 January 2008.

<sup>6</sup> J Leung, "Social security reforms in China: issues and prospects" (2003) 12 *International Journal of Social Welfare* 73.

This article will outline the new law with a particular focus on the corporate rescue provisions. Corporate rescue has dominated global insolvency law reforms this decade and it lies at the heart of the new Chinese law. Parts A outlines the context of the introduction of the new law by explaining the problems presented by uneconomic SOEs and also the manner in which they have been tackled. Part B addresses the need for corporate rescue laws to cater for private enterprises. Part C considers the forces that led to the introduction of the new law. Key features of the new law will be outlined in Part D, with a particular emphasis on the possible scope for state control. Finally some remaining barriers to the operation of the new law will be examined in Part E.

## **B. THE PROBLEMS OF UNECONOMIC SOES**

The planned economy was dominated by SOEs, which produced four fifths of the output from the manufacturing sector and employed two thirds of all industrial employees.<sup>7</sup> The planned economy was not however conducive to efficient and economic SOEs,<sup>8</sup> which were merely required to meet planned production targets.

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<sup>7</sup> NR Lardy, *China's Unfinished Economic Revolution* (Washington DC, Brookings, 1998), 25.

<sup>8</sup> Z Wei, O Varela and M Kabir Hassan, "Ownership and Performance in Chinese Manufacturing Industry" (2002) 12 *Journal of Multinational Financial Management* 61 note lower productivity in SOEs. On the benefits of private ownership in terms of efficiency see O Hart, A Shleifer and RW Vishny, "The Proper Scope of Government: Theory and an Application to Prisons"

There was no requirement for SOEs to turn a profit and, shielded from the pressures of competition there was no impetus for them to do so.<sup>9</sup> Moreover, in the absence of a social welfare system, SOEs were of great social significance in providing benefits to employees, retired workers and their families. In post reform China the workforce was dependent on SOEs for benefits such as wages, social security and health care: the so called “iron rice bowl” (*Tie Fan Wan*).<sup>10</sup> Financial support from the state was not direct but rather was filtered through the enterprise. Not only did SOEs provide welfare benefits for their employees but they were also widely reported to be overstaffed.

The extent of the social obligations placed on SOEs and their lack of budgetary constraints meant that they lacked a commercial basis and made it difficult for them to achieve profitability. This in turn led to pressures on the state banks. To keep uneconomic SOEs going, state banks were commonly directed by the state to advance loans to SOEs. Such loans were based on compulsion, rather than

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(1997) 112 *Quarterly Journal of Economics* 1127; and A Shleifer, “State Versus Private Ownership”

(1988) 12 *Journal of Economic Perspectives* 133.

<sup>9</sup> On the problems presented by SOEs see CA Holz, *China’s Industrial State-Owned Enterprises: Between Profitability and Bankruptcy* (Singapore, World Scientific, 2003).

<sup>10</sup> S Cook, “From Rice Bowl to Safety Net: Insecurity and Protection during China’s Transition” (2002) 20 *Development Policy Review* 615.

commercial principles<sup>11</sup> and the potential for enforcement was limited. Loans to SOEs are reported to have constituted a significant proportion of lending by the state banks. Relatively recent estimates suggest that around 40% of such loans are non performing,<sup>12</sup> amounting to around US\$600 billion.<sup>13</sup> In consequence it was difficult for the state owned banks to operate on a commercial basis.

The problem of uneconomic SOEs was in part addressed with the enactment of the Enterprise Bankruptcy Law (for Trial Implementation),<sup>14</sup> which was introduced in

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<sup>11</sup> NR Lardy, *supra*, n 7, 83.

<sup>12</sup> M Wolf, "Why is China Growing So Slowly?" (2005) 146 *Foreign Policy* 50, 51. A more modest rate is indicated by statistics provided by the China Banking Regulatory Commission, showing that state banks hold about RMB 1251,78 billion in non-performing loans, which account for 6.17 per cent of the total commercial loans: see <http://www.cbrc.gov.cn/chinese/home/jsp/index.jsp> accessed on January 29 2008.

<sup>13</sup> M Barker and R Purser, "Moving China's Goalposts" (2005) 2 *International Corporate Rescue* 328, 329.

<sup>14</sup> Adopted at the 18<sup>th</sup> Meeting of the Standing Committee of the Sixth National People's Congress and Promulgated by Order No. 45 of the President of the People's Republic of China, December 2 1986. English translation at [www.novexc.cn/enterprise\\_bankruptcy.html](http://www.novexc.cn/enterprise_bankruptcy.html) accessed on 29 January 2008 and DG Boshkoff and Y Song, "China's New Bankruptcy Law: A Translation and Brief Introduction" (1987) 61 *American Bankruptcy Law Journal* 359. See Ta-Kuang Chang, "The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process" (1987) 28

1986<sup>15</sup> for implementation in relation to SOEs<sup>16</sup> so that inefficient and outdated enterprises could be weeded out.<sup>17</sup> This law may be characterised as lacking in detail, subject to excessive restrictions and to too much state intervention in proceedings. It contains both liquidation and corporate rescue procedures.<sup>18</sup> In

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*Harvard International Law Journal* 333 on the background to this law and Z Xiao, "China's Bankruptcy Law: Socialist in Characteristic, Capitalist in Methods" (1989) 10 *Company Lawyer* 58.

<sup>15</sup> This was not the first occurrence of bankruptcy laws in China. Such laws had been introduced in 1906 but had been abolished in 1949 with the founding of the PRC. See further S Li, "Bankruptcy Law in China: Lessons of the Past Twelve Years" (Winter 2001) V *Harvard Asia Quarterly* <http://www.asiaquarterly.com/content/view/95/40/> accessed 29 January 2008; and L Cocks, "Chinese Insolvency Law: a Précis of Recent Changes" (2005) 2 *International Corporate Insolvency* 184, 185.

<sup>16</sup> 1986 Law, Article 2.

<sup>17</sup> Ta-Kuang Chang, "The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process" (1987) 28 *Harvard International Law Journal* 333, 336, reporting the conclusion of a study by the Technology and Economics Research Centre of the State Council.

<sup>18</sup> An enterprise is regarded as bankrupt if it is unable to pay its debts when due on account of serious losses due to mismanagement: 1986 Law, Art. 3. The requirement of mismanagement is an unusual restriction that cuts down the scope of applicability, since firms that have lost money due to seasonal factors, for example, may be just as deserving of assistance. Moreover the decision as to whether mismanagement has occurred may lead to unnecessary delay. The mismanagement element is notably absent from the Shenzhen bankruptcy law: Art. 3, discussed in X Zhang and CD Booth, "Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience" (2001) 15 *Columbia Journal of Asian Law* 1, 7.

spite of its long history there have been comparatively few bankruptcy proceedings brought under the 1986 law,<sup>19</sup> for example only 32 cases in 1990, and although this statistic rose exponentially, "from 277 in 1989-93 to 2,100 in 1994-95 and further to 5,640 in 1996-97",<sup>20</sup> this represented only an estimated 1.5% of SOEs.<sup>21</sup> This lack of usage was not due to a shortage of suitable cases for treatment but rather the social catastrophe that widespread bankruptcies would create.

Legal restrictions enabled tight control to be exerted by the state on the number of bankruptcies. A SOE could only file for bankruptcy with the permission of the government authority in charge.<sup>22</sup> SOEs also could be shielded from bankruptcy proceedings under Article 3 of the Bankruptcy Law if they carried on business as a public utility enterprise, or an enterprise with an important relationship to the national economy and the people's livelihood, such as a petrol company, and for which the relevant government departments granted subsidies or adopted other measures to assist the repayment of debts. This provision enabled bankruptcy proceedings to be avoided in cases where a government authority provided finance.

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<sup>19</sup> Li, *supra* n 15, citing statistics from the Supreme Court Annual Work Report.

<sup>20</sup> World Bank "Bankruptcy of State Enterprises in China: a Case and Agenda for Reforming the Insolvency System" (2001) <http://www.worldbank.org.cn/English/Content/485a6232469.shtml> accessed 29 January 2008.

<sup>21</sup> *Ibid.* NR Lardy noted an estimated bankruptcy rate of only 0.06% in 1996: *supra* n 7, 273.

<sup>22</sup> 1986 Law, Article 8.



Where bankruptcies took place they were carefully planned (based on the documents issued by the State Council respectively in 1994, 1997 and 2000).<sup>23</sup> In cases where the law was to be implemented the approval of the National Bankruptcy Liaison and Group, which is organised by the State Council, was required.<sup>24</sup>

The manner in which the 1986 law was drafted also enabled the state to exert control over the opening of reorganisation proceedings, since only the government authority was able to apply for reorganisation.<sup>25</sup> Therefore, the reorganisation

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<sup>23</sup> Planned bankruptcy or administrative closure was created and implemented concomitant with the Capital Structure Optimisation Programme (CSOP) in 1994, in which the State Council issued a document, entitled “Pronouncement Concerning the Trial Implementation of the Bankruptcy Law for SOEs in Certain Cities”, that guided the bankruptcy of SOEs of 18 “test point” cities excluding the 1986 law. The scope of this project was enlarged to 56 cities in 1996 and 111 cities in 1997. In 1999 the scope was expanded to national level. This meant that as long as the merger and bankruptcy of one SOE was listed in the national programme of the central government, it should first follow the rules established by the State Council. For details see Alan CW Tang, *Insolvency in China and Hong Kong: A Practitioner’s Perspective* (Sweet & Maxwell Asia, 2005), paras.5.80-5.81; Y Sun, *Bankruptcy Law: Legal Theory and Practical Analysis* (Beijing, People’s Court Press, 2003), 18-22 (in Chinese).

<sup>24</sup> Jingxia Shi, “Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China’s Transition to a Market Economy” (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 645, 652.

<sup>25</sup> 1986 Law Article 17.

proceedings could not be invoked without the approval of the government.<sup>26</sup> Not only was it extremely limiting that the debtor was not entitled to petition for rescue; but also the creditor's attempt to salvage the financially struggling enterprise could be blocked by government intervention. The commencement of proceedings was therefore out of the hands of creditors. In consequence the reorganisation process was strongly politicised and it undoubtedly hampered the functioning of the rescue procedure, resulting in very low, possibly non-existent, use of the procedure.<sup>27</sup>

Corporate rescue proceedings commonly will entail a reorganisation of the business which will be accompanied by a reduction in the workforce. The greater the proportion of employees who are retained the more costly the rescue efforts potentially become. In China the social welfare system was inadequate to meet what was a significant unemployment problem and this led to state interference in insolvency proceedings. For example it has been reported that, since local governments are responsible for the resettlement of redundant employees, these governments will not approve bankruptcy proceedings unless there was provision

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<sup>26</sup> See DC Clarke, "Regulation and its Discontents: Understanding Economic Law in China" (1992) 2 *Stanford Journal of International Law* 283, 299-300.

<sup>27</sup> See W Wang, "Adopting Corporate Rescue Regimes in China: A Comparative Survey", (1998) 9 *Australian Journal of Corporate Law* 234, section 3.1; and also the comments on the website <[www.asianrestructuring.com](http://www.asianrestructuring.com)>.

for such resettlement,<sup>28</sup> although this requirement was understandable in light of the destitution that redundant employees might otherwise face,<sup>29</sup> in particular in cases where social security provision is inadequate or unavailable.<sup>30</sup>

Rather than liquidating struggling SOEs, efforts in many cities were directed at restoring SOEs to financial health by a process of mergers and restructuring through a hiving off of unproductive units.<sup>31</sup> These mergers were the preferred means of dealing with struggling SOEs, rather than bankruptcy proceedings.<sup>32</sup> In such cases autonomous legislation was applicable, but was not permitted to contradict the rules and principles which were established by national law. There was also a place for informal arrangements and debt restructuring,<sup>33</sup> as in Changchun style debt

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<sup>28</sup> X Lan, "Outdated Bankruptcy Law Updated" [http://www.bjreview.com.cn/200430/Business-200430\(B\).htm](http://www.bjreview.com.cn/200430/Business-200430(B).htm) accessed 27 October 2006.

<sup>29</sup> F Chen, "Subsistence Crises, Managerial Corruption and Labour Protests in China" (2000) 44 *The China Journal* 41, 45-50, describing the destitution faced by redundant employees and consequent examples of unrest.

<sup>30</sup> Y Zhu, "Recent Developments in China's Social Security Reforms" (2002) 55 *International Social Security Review* 39, 46, noting that unemployment benefit was concentrated in certain cities.

<sup>31</sup> Li, *supra* n 15.

<sup>32</sup> L Burton, "An Overview of Insolvency Proceedings in Asia" (2000) 6 *Annual Survey of International & Comparative Law* 113, 119.

<sup>33</sup> The Enterprise Bankruptcy Law is not the only relevant law. It was supplemented by chapter 19 of Civil Procedure Law 1991, containing insolvency laws applicable to non SOEs, by

restructuring – a market-oriented approach sponsored by government and debt restructuring by asset management companies (AMCs).<sup>34</sup> Merger activity is one of the key means of maximising the potential of businesses, since it can entail a rationalisation of resources and an overhaul of a board of directors who may be underperforming. Indeed it has been argued that the threat of a takeover is one of the key incentives for directors to maximise their performance,<sup>35</sup> however such benefits only arise as a result of properly functioning market forces. Commonly in China the government would attempt to force a profitable and well running enterprise to merge with a loss making one, regardless of the economic considerations.<sup>36</sup>

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guidance released by the Supreme Court in 1991, which was revised in 2002 and also by documents issued by the state council setting out policies applicable in selected cities. Other local schemes were developed in Special Economic Zones, such as in Shenzhen. See Zhang and Booth, *supra* n 18. For a detailed list of applicable laws see R Tomasic and M Wang, “The Long March Towards China’s New Bankruptcy Law”, in R Tomasic (ed), *Insolvency Law in East Asia* (Ashgate, 2006), 95-98.

<sup>34</sup> See comments of CD Booth in “Corporate/Debt Restructuring: Japan, the Hong Kong SAR & the People’s Republic of China - A Roundtable Discussion” (2002) 10 *American Bankruptcy Institute Law Review* 1, 23.

<sup>35</sup> See e.g. C Bradley, “Corporate Control: Markets and Rules” (1990) 53 *Modern Law Review* 170.

<sup>36</sup> The merger of Shanxi Yuncheng Detergent Factory in 1994 is a typical example. The details of the case are available at: Alan CW Tang, *supra* n 23, para.5.88-5.91.

A gradual and tightly controlled approach was taken to the reduction of the workforces. Such a process began in 1987 with a provision *youhua zuhe* that enabled excess workers to be laid off. The approach favoured re-employment of such workers, rather than monetary provision by the state. Workers were commonly “internally absorbed” by reemployment by a subsidiary of the SOE established for example to run a business such as a restaurant or shop.<sup>37</sup> Other redundancies on a significant scale followed in 1992 but enterprises were required to provide employees with continued income, although often at an inadequate level and without medical insurance.<sup>38</sup> More sustainable means of re-employment of workers were developed.<sup>39</sup> New employers were encouraged to take on redundant employees by means of tax benefits and redundant employees were given assistance in setting up their own businesses. In addition, restrictions which limited employees to particular geographical areas were gradually removed.

This process has had many positive effects: over 3,370 debt-laden SOEs went bankrupt through planned bankruptcy, and 223.8 billion yuan of non-performing

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<sup>37</sup> Chen, *supra* n 29, 46; and generally L Wong and K Ngok, “Social Policy between Plan and Market: Xiangang (Off Duty Employment) and the Policy of the Re-employment Service Centres in China” (2006) 40 *Social Policy and Administration* 158.

<sup>38</sup> *Ibid* at 46-7.

<sup>39</sup> Wong and Ngok, *supra* n 37, 168-9.

loans were dealt with.<sup>40</sup> Although 6.2 million workers were made redundant the government made significant efforts to find alternative employment for them. However it also led to undue government intervention and unfair competition between the SOEs and privately owned enterprises and foreign owned enterprises. In light of the impact of the closure of SOEs on the workforce, special policies were applicable, giving preference to the employees' claims, which were ranked prior to secured claims. In addition, some SOEs used this opportunity to escape their debts, especially major debts owed to banks.

In addition to the planned closure of failing SOEs, efforts have been directed at introducing market based principles to viable SOEs. Accordingly hard budgetary constraints have increasingly been imposed upon SOEs in recent years.<sup>41</sup> SOEs underwent a process of corporatisation and either the state became the sole shareholder or outside investors were permitted under the control of the state.<sup>42</sup> This corporatisation was undertaken in the hope that it would lead to greater monitoring by investors and promote higher standards among managers. Managers

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<sup>40</sup> Y Xu, *The Speech on Enterprise Bankruptcy Law* (Beijing, Law Press-China, 2006), 408 (in Chinese).

<sup>41</sup> NR Lardy, *supra* n 7, 141; CA Holz, *supra* n 9, 308-9.

<sup>42</sup> L Miles and Z Zhang, "Improving Corporate Governance in State-Owned Corporations in China: Which Way Forward" (2006) 6 *Journal of Corporate Law Studies* 213, 216.

were given greater autonomy in the allocation of resources and outputs.

Diversified ownership was promoted through private enterprises, and foreign joint ventures. Corporatisation efforts intensified from 1997, as set out in proposals of the Fifteenth National Congress of the Communist Party and particularly the Fourth Plenum in 1999. The level of state ownership was reduced except in relation to industries related to national security; natural monopolies; industries providing important public goods and services; and pillar industries and backbone enterprises in high and new technology industries. At that time also the part to be played in the economy by non-SOEs was more expressly recognised, as the status of SOEs was downgraded from a “principal component” of the economy to merely a “pillar of the economy” and the part of privately owned enterprises was upgraded from a “supplementary component” of the economy to an “important component” of the economy. However the adoption of a change in managerial culture, after 40 years of state control, has been slow to take root.<sup>43</sup> Although in one survey profits among 169 SOEs were found to have risen,<sup>44</sup> this increase was largely accountable to

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<sup>43</sup> E M Freund, "Fizz, Froth, Flat: The Challenge of Converting China's SOEs into Shareholding Corporations" (2001) 18 *Policy Studies Review* 96.

<sup>44</sup> One analyst even went so far as to conclude that China's SOEs are no more loss making than US listed companies and that the proportion of uneconomic SOEs is now down to 32.4% (11,112 out of 34,280): Jonathan Anderson of investment bank UBS, quoted in <http://news.bbc.co.uk/1/hi/business/4534048.stm> page last updated 9 January 2006. These findings

only 12 companies, notably utility companies holding monopolies. Moreover it has been notoriously difficult to assess the worth of SOEs, due to inadequate accounting procedures<sup>45</sup> and unclear property ownership rights. There is therefore still considerable progress to be made.

### **C. THE RISE OF PRIVATE ENTERPRISES**

Accompanying the corporatisation of SOEs has been an increased role for privately controlled enterprises. The productivity of Chinese private enterprises has expanded significantly over time, with such enterprises having been found in a survey by the OECD in 2005 to account for well over half of GDP (59.2%), increased from barely a half of GDP (50.4%) in the late 1990s.<sup>46</sup> Notably the financing of this expansion of the private sector would appear to have come primarily from informal

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must however be treated with a note of caution, in view of the dangers that the financial information presented by the enterprises may be distorted.

<sup>45</sup> The Auditor General reported in 2001 that 68% of the accounts of 1290 of China's biggest companies were inaccurate: M O'Neill, "China Auditor in Shock Report", *South China Morning Post*, 8 January 2001.

<sup>46</sup> OECD Economic Surveys, 2005, No.13 - China. See also F Allen, J Qian and M Qian, "Law, Finance, and Economic Growth in China" (2005) 77 *Journal of Financial Economics* 57, 78.



sources, which may have a destabilising effect.<sup>47</sup> This reliance on informal sources arose because of significant reluctance to lend to private sector enterprises, in particular on an unsecured basis, on account of factors such as ambiguity in their legal status,<sup>48</sup> however formal lending to the private sector has risen<sup>49</sup> and is likely to rise further in the face of reforms to the banking sector, notably the influx of foreign lenders.

In spite of this importance of private sector firms to the economy there was hitherto no provision for them to benefit from corporate rescue proceedings. When the 1986 law was drafted the economy was dominated by SOEs, with few non SOEs. Therefore no provision was made in the Law for its application to non SOEs. The Civil Litigation Law of 9 April 1991, Chapter 19<sup>50</sup> was enacted to include bankruptcy provisions applicable to other enterprises with the status of legal persons, including privately owned enterprises. However the content of this law is

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<sup>47</sup> Further discussed in K Tsai, *Back Alley Banking: Private Entrepreneurs in China* (Cornell University Press, 2002). The relatively low level of lending to private enterprises is also noted in Allen et al, *ibid*, 70.

<sup>48</sup> K Tsai, "Beyond Banks: The Local Logic of Informal Finance and Private Sector Development in China," presented at a conference on Financial Sector Reform in China, Harvard Business School, and Massachusetts Institute of Technology, Cambridge, MA, September 11-13, 2001.

<sup>49</sup> Allen et al, *supra* n 46, 77.

<sup>50</sup> Procedures for Insolvency and Debt Repayment of Corporate Enterprises.

much more limited than that applicable to SOEs, in particular in that it omits corporate rescue procedures. There was some debate about whether the corporate rescue provisions in the 1986 law were capable of implementation in relation to non SOEs, with a statement to this effect by the Supreme Court,<sup>51</sup> however the details of this application were not fleshed out and the held view was that this statement could not prevail over what was set out in the Enterprise Bankruptcy Law. The absence of a reorganisation procedure in this law has proved to be damaging, necessitating such proceedings taking place on an unregulated basis. There are precedents for corporate rescue proceedings in the shadow of the law in the London Approach, under which major creditors are encouraged to cooperate to avoid placing undue and premature pressure on a debtor prior to the implementation of a plan of reorganisation or composition,<sup>52</sup> and which has

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<sup>51</sup> 1992 Opinions of the Supreme People's Court on Several Issues Concerning the Application of the Civil Procedure Law.

<sup>52</sup> See J Flood, R Abbey, E Skordaki and P Aber, *The Professional Restructuring of Corporate Rescue: Company Voluntary Arrangements and the London Approach* (London, ACCA, 1995); A Belcher, *Corporate Rescue* (London, Sweet and Maxwell, 1997), 117–122; V Finch, *Corporate Insolvency Law: Perspectives and Principles* (Cambridge University Press, 2002), 219–229; JH Armour and S Deakin, “Norms in Private Insolvency: the ‘London Approach’ to the Resolution of Financial Distress” (2001) 1 *Journal of Corporate Law Studies* 21.

influenced informal corporate rescue mechanisms in other countries.<sup>53</sup> However informal proceedings in China foundered in the face of an insufficient legal infrastructure.

#### **D. IMPETUS FOR REFORMS**

This changing economic climate has created a pressing need for corporate rescue laws, so that SOEs that are flagging in the face of their budgetary constraints can be aided and privately controlled enterprises can be assisted in the event of any economic downturn caused, for example, by a collapse in the real estate market.<sup>54</sup>

Although the 1986 law was originally introduced “for Trial Implementation” it has been durable, primarily due to the protracted nature of the reform process,<sup>55</sup> rather than the long term suitability of the 1986 law. Efforts to introduce a revised law began in 1994 but were hitherto stymied. The pivotal social role of SOEs

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<sup>53</sup> For example in Hong Kong, see B Ye and X Sa, “Hong Kong Corporate Rescue: Developments and Debate from a PRC Mainland Judge’s Viewpoint”, in K Gromek Broc and R Parry (eds), *Corporate Rescue* (Alphen aan den Rijn, Netherlands, Kluwer, 2006), Ch. 9. For a more general review see GE Meyerman, “The London Approach and Corporate Debt Restructuring in East Asia”, in C Adams, RE Litan and M Pomerleano, *Managing Financial and Corporate Distress: Lessons from Asia* (Washington, Brookings Institution Press, 2000), 299-322.

<sup>54</sup> Brian Bremner, "Banking on China's Reforms" *Business Week*, February 6 2006.

<sup>55</sup> See Shi, *supra* n 24, 645, 654.

contributed not only to their financial difficulties but it also delayed the process of reform to the insolvency laws. It was felt that a process of rapid reform would generate high social costs in the form of unemployment and the growth of a social divide in wealth, leading to instability and rioting.<sup>56</sup> For these reason the process of reform could only be gradual.<sup>57</sup>

A modernised bankruptcy law which particularly emphasized corporate rescue was submitted to the Standing Committee of National Peoples Congress (NPC) in 1995, but was rejected because of fears about its potential social impact. After that, there were several occasions on which the bankruptcy law programme was included in the legislative schedule but was suspended. There were both internal and external pressures towards the introduction of the new law. Internally there was lobbying by banks. Externally, there were significant political pressures. Notably the denial

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<sup>56</sup> Wong and Ngok, *supra* n 37, 158-9. In August 2005, Zhou Yongkang, Minister of Public Security, announced that 3.7 million citizens had participated in over 74,000 mass incidents in 2004. Disturbances are reported to have increased to 87,000 in 2005: Richard McGregor, "Data show social unrest on the rise in China" FT.com, January 19, 2006, but to have fallen in 2006: Richard McGregor, "Beijing reports decline in protests" FT.com, November 8, 2006.

<sup>57</sup> In contrast, in Eastern European countries such as Hungary the painful process of dismantling SOEs that were no longer economically viable took place in the early 1990s at a relatively rapid pace. See PG Hare, "From Central Planning to Market Economy: Some Microeconomic Issues" (1990) 100 *The Economic Journal* 581, 583-4 on earlier reforms.

by the EU of recognition of China as having a market economy status was attributable in part to its absence of bankruptcy proceedings.<sup>58</sup> The absence of effective bankruptcy laws has been regarded as contributing to the dumping by Chinese manufacturers of goods at below cost price, and it is a factor that is examined by anti dumping regulators in assessing whether a firm operates in a market economy.<sup>59</sup> A lack of market economy status leads to higher anti dumping levies, which may in turn prevent access to markets, deter foreign investment and inhibit the development of industries.

In light of these pressures, the new bankruptcy and reorganisation law, which embodied significant efforts of draftsmen, went through a final reading on the 23rd meeting of the 10th session of Standing Committee of NPC in August 2006. The passage of this law was ultimately smoothed by reforms in areas of particular

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<sup>58</sup> More recently the introduction of the new bankruptcy law has been praised by EU Trade Commissioner Peter Mandelson in a speech of 10 July 2007, although he also noted that there was some way to go towards recognition of market status, notably in removing barriers to access to the Chinese market and in the protection of intellectual property requirements. The text of the speech is available at [http://ec.europa.eu/commission\\_barroso/mandelson/speeches\\_articles/sppm162\\_en.htm](http://ec.europa.eu/commission_barroso/mandelson/speeches_articles/sppm162_en.htm) accessed 29 January 2008.

<sup>59</sup> Council Regulation (EC) No 384/96 of 22 December 1995 on protection against dumped imports from countries not members of the European Community, Article 2(7)(b).

concern, including in relation to the social security system,<sup>60</sup> and by reforms to uneconomic SOEs, outlined above. Steps have also been taken to protect the position of the banks.

The availability of appropriate and effectively functioning insolvency laws will enable investors and creditors to plan their dealings with Chinese companies more effectively and to have confidence that in the event of insolvency the proceedings will be conducted fairly and that fraudulent dealings or unfair preferences will be tackled. This stability can promote investment that might not otherwise take place,<sup>61</sup> although in addition to the presence of such laws it will be necessary that there is a sufficient prospect of their application and enforcement. Around \$60bn

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<sup>60</sup> See K Lin and O Kangas, "Social Policymaking and its Institutional Basis: Transition of the Chinese Social Security System" (2006) 59 *International Social Security Review* 61; Joe CB Leung, "Social Security Reforms in China: Issues and Prospects" (2003) 12 *International Journal of Social Welfare* 73.

<sup>61</sup> The European Bank for Restructuring and Development has noted a correlation between the effectiveness of a country's bankruptcy laws and the level of foreign direct investment in that country: [Spring 2000] *Law in Transition* 43. See also R La Porta, F Lopez de Silanes, A Shleifer and RW Vishny, "Legal Determinants of External Finance" (1997) 53 *Journal of Finance* 1131 and C J Tabb and A Curtis Campbell "The Importance of Bankruptcy Law to Economic Development and Implications for China" (2006) 22 *Insolvency Law and Practice* 98. A vom Eigen, "China's New Bankruptcy Law Encourages Investment" (2006) 25 *American Bankruptcy Institute Journal* 8 notes the possible impact of the new law.

was invested in China in both 2004 and 2005 and this amount looks set to rise in 2006. However an absence of stability can place the economic system in danger of a sudden withdrawal of foreign investment, leading to an economic crisis.<sup>62</sup>

Hitherto the state has sought to provide stability by maintaining strong control on the economy. However with accession to the WTO the difficulty of this task will increase, moreover the expectation of foreign investors<sup>63</sup> will be that the rule of law

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<sup>62</sup> B Eichengreen, *Toward a New Financial Architecture* (Washington DC, Institute for International Economics, 1999), 28.

<sup>63</sup> Foreign investors may have differing attitudes to this issue however and the existence of the rule of law is more likely to be a factor influencing the decisions of Western investors, some concerns for whom are highlighted by L Wilson, "Investors Beware: the WTO Will not Cure All Ills with China" [2003] *Columbia Business Law Review* 1007. It is significant that China has benefited to large extent from investment by Chinese diasporic subjects, encouraged by Deng Xiaoping. The driving force for such investment may be culturally different from that of Western investors, being based on personal connections and patriotism, in addition to the desire to turn a profit, and such investors have been able to find solutions to problems without recourse to the law. These matters are explored by Maggi WH Leung, "From "Bamboo Networks" to Transnational Hi-tech Linkages: Overseas Chinese as Agents for Economic Development in the PRC", paper presented at the XVI Conference of the European Association of Chinese Studies, Ljubljana, 1 September 2006 (paper on file with authors), citing one estimate that investment from overseas Chinese represents 70 to 80 per cent of FDI in China. These issues are also touched upon in S Lubman, "Looking for Law in China" (2006) 20 *Columbia Journal of Asian Law* 1, 51-2.

will hold sway and property rights will be upheld.<sup>64</sup> The challenge in the continued liberalisation of the economy will be to replace state control with these and other stabilising mechanisms including sound corporate governance mechanisms, as a means of minimising the potential for corporate collapses, and the effective employment of corporate rescue procedures to handle such collapses.

Corporate rescue procedures are emphasised under the new law that, for the first time, will be available to businesses that are not owned by the state. Corporate rescue laws enable struggling but viable companies to recover economic stability, or at least to retain economic value by preserving the company's business for sale to another enterprise.<sup>65</sup> Belcher defines the concept as "a major intervention necessary to avert the eventual failure of the company"<sup>66</sup> and notes that this term can encompass both formal and informal rescue processes. The focus in this article will primarily be on formal processes. Such processes commonly provide the company with temporary protection from creditors, so that efforts to find a solution to the company's financial difficulties are not undermined by demands from

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<sup>64</sup> It is notable, however, that significant investment has been already been attracted in spite of an apparent absence of the rule of law. See R Peerenboom, *China's Long March Toward Rule of Law* (Cambridge University Press, 2002), 462-475 for an evaluation of possible explanations and Lubman, *supra* n 63 for a discussion of ways in which investors cope in the absence of the rule of law..

<sup>65</sup> For a detailed discussion, see A Belcher, *supra* n 52; and V Finch, *supra* n 52, Ch. 6.

<sup>66</sup> A Belcher, *ibid*, 4.



creditors; a framework for the negotiation of a plan for the fulfilment of the company's obligations; and voting procedures for the implementation of this plan. The company will either be managed by its existing management (debtor in possession proceedings), with or without supervision by a qualified insolvency professional, or such a professional will assume control of the company (termed by Finch as "practitioner in possession" proceedings).<sup>67</sup> The procedures may be subject to oversight by a court.<sup>68</sup>

The new Chinese laws are part of a global trend of developments in this area. Increasing attention worldwide has been focussed on the development of optimal corporate rescue laws and the Chinese draftsmen took account of the work done in this area. Reforms have taken place throughout Europe,<sup>69</sup> also in countries such as the United States,<sup>70</sup> Japan,<sup>71</sup> Mexico,<sup>72</sup> Brazil,<sup>73</sup> and Turkey<sup>74</sup>. The World Bank has

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<sup>67</sup> V Finch, "Control and Co-ordination in Corporate Rescue" (2005) 25 *Legal Studies* 374, 374-5.

<sup>68</sup> See World Bank, *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*, (Revised 2005), C14.1 for an overview of desirable features of a corporate rescue system.

<sup>69</sup> See K Gromek Broc and R Parry (eds), *Corporate Rescue, An Overview of Recent Developments from Selected Countries in Europe* (The Hague, Kluwer, 2004).

<sup>70</sup> PB Lewis, "Corporate Rescue Law in the United States" in K Gromek Broc and R Parry (eds), *supra* n 53, Ch 16.

been a key player in pushing for reforms to corporate insolvency laws worldwide and has, in conjunction with UNCITRAL, has developed *Principles and Guidelines for Effective Insolvency and Creditor Rights Systems*. It emerges strongly from the reform process that no appropriate “one size fits all” approach to such laws can be devised.<sup>75</sup> For example the World Bank/UNCITRAL *Principles and Guidelines* provide a very skeletal approach, reflecting the importance of adaptation in light of national differences. Account must be taken of the political, social, cultural, institutional and economic environment in each country. Corporate rescue laws do not operate in a vacuum, but are shaped by diverse factors including conceptions of

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<sup>71</sup> For an overview see Hon SL Bufford and K Yanagida, "Japan's Revised Laws on Business Reorganization: An Analysis" (2006) 39 *Cornell International Law Journal* 1.

<sup>72</sup> *Ley du Concursos Mercantiles* of May 13 2000, discussed in Luis Manuel C. Méjan, “The Genesis, Structure and Projection of the New Mexican Insolvency Law” (2001) 17 *Connecticut Journal of International Law* 79.

<sup>73</sup> Law No. 11.101 of February 9, 2005.

<sup>74</sup> Law No. 4949 Amending the Turkish Bankruptcy and Execution Law, Official Gazette 30 July 2003 and numbered 25184; numbered 5092 Amending the Turkish Bankruptcy and Execution Law, Official Gazette 21 February 2004, numbered 25380.

<sup>75</sup> In this regard it is perhaps notable that the European Union chose to adopt the open method of coordination in relation to insolvency laws, compared with the maximum harmonization approach envisaged for areas of consumer protection and capital market laws e.g. EU Directive on

the company, the corporate governance system, the persuasive influence of the banking sector, the level of paternalism of the state, and the culture of company managers. Therefore it is not feasible for a mature system of corporate rescue laws to be merely transplanted into a developing legal system without considered and appropriate modification.<sup>76</sup>

The new corporate rescue laws will be particularly important if the country undergoes a period of financial turbulence, caused by an increase in the price of raw materials, a loss of demand for products, or a slump in foreign investment, when it will be important for adequate corporate rescue laws to be in place. The impact of the East Asian financial crisis in 1997 was worsened by a lack of adequate corporate rescue laws, which made the rehabilitation of struggling companies more difficult. There were insufficient mechanisms to protect companies by granting to them a period of breathing space in which to get their affairs in order and to facilitate fresh financing that would invigorate the enterprise by granting such financing priority in

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the Distance Marketing of Consumer Financial Services (2002/65/EC); and the EU Prospectus Directive (2003/71/EC). See R Parry, "Introduction", in Gromek Broc and Parry, *supra* n 6969, 5-8.

<sup>76</sup> On the problems and strategies of transplantation see F Dahan and J Dine, "Transplantation for Transition — Discussion on a Concept Around Russian Reform of the Law on Reorganisation" (2003) 23 *Legal Studies* 284.

the queue for payment.<sup>77</sup> Moreover corporate rescue laws are needed in a market orientated economy regardless of the economic climate, as even when the economy is healthy some enterprises will inevitably experience financial distress, due to poor management, fraud, or poor cash flow, but with appropriate assistance they can often be restored to viability.

## **E. THE CORPORATE RESCUE CULTURE IN CHINA'S NEW ENTERPRISE**

### **BANKRUPTCY LAW 2006**

Although the new law marks a transition from planned bankruptcies to market based proceedings, it would be naïve to think that the scope for state interference in proceedings has disappeared completely. As discussed below, significant potential for state control arises through the judiciary and through the appointment of an administrator.<sup>78</sup>

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<sup>77</sup> See M Pomerleano and W Shaw, *Corporate Restructuring: Lessons from Experience* (World Bank, 2005), 101-125.

<sup>78</sup> The term "administrator" is used by Tang, *supra* n 23, para. 5.38; EJ Chua, "China's Central Government Sets Short Timetable For Bankruptcy Law Reform" (2005) 20 *Journal of International Banking Law and Regulation* 611; Wang, *supra* n 27, section 4.3

The discussion below will concentrate on a number of key aspects of the new law, relating to 1) conditions of access to the proceedings; 2) the process of administration of the opening of proceedings; 3) the treatment of those affected by the insolvency; 4) the governance of the proceedings and 5) the framework for the agreement of a rescue plan. Although the focus is on the rescue procedures, reference will be made, where appropriate, to the liquidation regime. The presence of effective liquidation procedures will potentially encourage company managers to seek the alternative of corporate rescue at an early stage. In addition, a major incentive for creditors to support corporate rescue proceedings is the potentially better return that they will receive by agreeing to the plan proposed by the debtor, compared with what they would receive in liquidation. There will then follow in Part D a discussion of some additional factors relevant to the specific situation of China that will present challenges in the operation of the new law and may limit its immediate impact. It is notable that the operation of the law in practice may bring some surprises in its operation. Further revisions to the law may be necessitated, as shown by the experience of a great many mature bankruptcy systems which have recently undergone reforms.<sup>79</sup>

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<sup>79</sup> See Gromek Broc and Parry (eds), *supra* n 69; and Gromek Broc and Parry (eds), *supra* n 53.

## I. Access to the proceedings

One strength of the new law is that it has removed the obstacles to the commencement of bankruptcy and reorganisation proceedings which were prescribed by the previous law.<sup>80</sup> The new law is to apply to a greater range of businesses with the status of “legal person”: namely SOEs, non SOEs and financial institutions but not individuals and partnerships.<sup>81</sup> In keeping with the market based nature of the new law, there is no requirement of government consent to bankruptcy proceedings, and accordingly the resettlement of employees will not be a central concern. On the fact of it the new law should not therefore be subject to the same distortions as under the 1986 law. However, as discussed below, it likely that these factors will still be present in practice in the operation of the new law.

A company will be eligible for bankruptcy proceedings, either liquidation or rescue, if it cannot pay its due debts and either its assets are insufficient to enable it to meet all of its debts or it evidently lacks repayment capacity.<sup>82</sup> The requirements of these elements will need to be fleshed out in time, since it is unclear for example if one unpaid invoice of a significant value will suffice as evidence of a company's inability to

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<sup>80</sup> The former requirement of managerial misconduct is gone, which removes a significant obstacle to the implementation of proceedings.

<sup>81</sup> 2006 Law, Article 2.

<sup>82</sup> *Ibid.* See J Shi, *supra* n 24, 657-8.

meet its debts, or if a more significant range of evidence of such inability is required.

Notably both elements must be satisfied, which may limit access to the proceedings.

In addition, there will be another route for reorganisation proceedings if it can be shown that the debtor is obviously likely to lose repayment capacity.

Under this law the company or a creditor must apply to the court for bankruptcy proceedings. The reorganisation procedure can be invoked directly based on the petition presented either by the company or a creditor to the court. In addition, in the circumstances where a creditor has applied to the court for bankruptcy, the debtor or the shareholders who contribute to more than 10% of the registered capital of the company are able to petition for rescue before the court declares bankruptcy of the debtor.<sup>83</sup> Early implementation of rescue proceedings will normally lead to a more successful outcome than if proceedings are delayed, since the company will be shielded from the demands of creditors at an early stage and the timely provision of expert help can prevent problems from ballooning.<sup>84</sup> At least in the short term however there may be problems in opening proceedings at a sufficiently early stage. It is likely that there will be a lack of awareness of the potential for rescue. In addition business managers may be reluctant to admit that

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<sup>83</sup> 2006 Law, Article 70, see also Y Xu, *The Speech on Enterprise Bankruptcy Law* (Beijing, Law Press-China, 2006), 301 (in Chinese).

<sup>84</sup> Wang, *supra* n 27, section 2.4.

their business is in difficulties and they may fear that they will lose their jobs if proceedings are initiated.<sup>85</sup>

Might the impetus for early action come from creditors? Statistics indicate that among listed companies around 30% of financing comes from bank loans and 45% from other sources, including funds raised from issues of shares and bonds.<sup>86</sup> As noted above, rates of bank lending to the private sector have been low but are increasing. Such businesses commonly raise capital from friends and family, from private equity and from loans. The rules on which companies may issue bonds have recently been liberalised<sup>87</sup> and so it may be expected that there will be a rise in such financing. However it has also been predicted that informal financing within the private sector may be durable.<sup>88</sup> Some creditors may be reluctant to go to court owing to a cultural aversion to litigation, and a lack of confidence in the judiciary, arising from weaknesses in the legal infrastructure.<sup>89</sup> Moreover there has

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<sup>85</sup> BG Carruthers and TC Halliday, *Rescuing Business* (Oxford, Clarendon Press, 1998), 249-251;

R Parry, "Introduction", in Gromek Broc and Parry (eds), *supra* n 69, 14.

<sup>86</sup> Allen et al, *supra* n 46, 80.

<sup>87</sup> Gu Minkang, *Understanding Chinese Company Law* (Hong Kong University Press, 2006), p.334-

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<sup>88</sup> Kelle Tsai, *supra* n 47, 262-263.

<sup>89</sup> On the limits of the rule of law in China see SB Lubman, *Bird in a Cage - Legal Reform in China After Mao* (Stanford, Stanford University Press, 1999); Peerenboom, *supra* n 64. See also C de Vera,



historically been pride among many Chinese citizens in the absence of bankruptcy from the economy.<sup>90</sup> However it may be that a culture of intervention will develop among the banking sector, in particular since the banking market has been opened up. The development of early intervention will be important, as delay may be caused to such an extent that the optimal time for the implementation of rescue proceedings will be missed, or even that the company will no longer be salvageable.

## **2. Administration of the opening of proceedings**

Once the application has been filed the court will then decide within 15 days whether to grant a request for liquidation proceedings, although this time limit can

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“Arbitrating Harmony, 'Med-Arb' and the Confluence of Culture and Rule of Law in the Resolution of International Commercial Disputes in China” (2004) *Columbia Journal of Asian Law* 149, 174 on cultural reasons for an aversion to litigation and a preference for arbitration. See also BKY Wong, “Chinese Law Traditional Chinese Philosophy and Dispute Resolution” (2000) 30 *Hong Kong Law Journal* 304, 316-7. However H Lu and TD Miethe note that “the Chinese public has increasingly turned to legal redress for dispute resolution in record numbers since the economic reforms. For example, the number of civil disputes adjudicated in courts has nearly tripled between 1988 and 2000 (from 1.2 million to 3.4 million), whereas lawsuits filed against state agencies for unfair or illegal administrative decisions have increased tenfold (from 8,573 cases to 85,760) during this time period”. See “Confessions and Criminal Case Disposition in China” (2003) 37 *Law and Society Review* 549, 554 citing the *Law Yearbook of China* (1988, 2001).

<sup>90</sup> Gu Minkang, *supra* n 87, 279.

be extended to another 15 days after the approval of the upper-level court.<sup>91</sup>

There is no time limit within which a court must decide whether or not to grant the petition for reorganisation. This may prove to be a problem because there is no statutory moratorium in the period from the date when the petition is presented to the date when the sanction for reorganisation is made by court.<sup>92</sup> The company may therefore be vulnerable, in particular if the opening of proceedings is delayed.

The court has a wide discretion to decide whether or not to sanction reorganization proceedings. The principles that it should observe in reaching its decision have not been elaborated and consequently the courts would appear to have considerable margin to influence the conduct of proceedings, which could lead to distortions in the use of these procedures.<sup>93</sup> It is submitted that this lack of guidelines may enable the court to become the main obstacle to the use of these procedures.

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<sup>91</sup> See the 2006 Law, Article 10.

<sup>92</sup> Although a moratorium inevitably interferes with the property rights of creditors it is an essential tool facilitating a resolution of the difficulties of companies in most corporate rescue systems. See generally Carruthers and Halliday, *supra* n 85, p 40-42; and D Milman, "Moratoria on Enforcement Rights: Revisiting Corporate Rescue" [2004] *Conveyancer and Property Lawyer* 89. Finch, *supra* n 52, 206-207, offers a brief review of moratoria provision in different jurisdictions.

<sup>93</sup> See Carruthers and Halliday, *supra* n 85, 480-3, describing problems of political cronyism in the United States bankruptcy judiciary and for a more recent study of distortions caused by the courts system LM Lo Pucki, *Courting Failure* (Ann Arbor, University of Michigan Press, 2006).

Under the current political and legal environment, government authority may exert considerable pressure on the judiciary,<sup>94</sup> in spite of the fundamental importance of judicial independence under the Chinese Constitution. In contrast, the reorganisation provisions are drafted in a manner that indicates that if the court considers that the application meets the requirements of the legislation it has no discretion and it must make an order for reorganisation.<sup>95</sup> However it will take time for the judiciary to develop expertise and experience in handling corporate rescue cases.

The court has a monopoly over the appointment of an administrator to manage the debtor's affairs,<sup>96</sup> reflecting the view that the administrator has an independent function and is not merely a representative of creditors.<sup>97</sup> However a creditors' meeting will also be established, and this body is entitled to apply to the court for a change of administrator if it can argue that the administrator is not capable of discharging his duties legally and impartially, or that he is incompetent at his work, but only the court has the final say.<sup>98</sup> Little guidance as to the appointment process

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<sup>94</sup> Peerenboom, *supra* n 64, 18.

<sup>95</sup> 2006 Law, Article 71. J Shi, *supra* n 24, 667.

<sup>96</sup> 2006 Law, Article 22.

<sup>97</sup> J Shi, *supra* n 24, 663.

<sup>98</sup> See the 2006 Law, Article 22. Y Xu, *The Speech on Enterprise Bankruptcy Law* (Beijing, Law Press-China, 2006), 185-186 (in Chinese).

is given in the legislation but Provisions on the Appointment of Administrators in Hearing Bankruptcy cases have issued by the Supreme Peoples Court. These Provisions indicate that a roster of administrators should be established locally from which the court should make an appointment by random means, which is in the interests of the integrity of the proceedings. A competitive bidding process will be employed in relation to cases that are complex and significant and one fear may be that this element of the appointment process could be manipulated. In recognition of the complexities of insolvencies of financial institutions, regulatory bodies will make a recommendation in respect of the appointment in such cases.

Notably the debtor may apply to manage the estate with administrator support, under “debtor in possession” proceedings. The availability of debtor in possession proceedings is an innovation for China and is potentially useful as a means of getting the business into the bankruptcy proceedings at a sufficiently early stage.<sup>99</sup>

Experience demonstrates that the sooner the rescue proceedings are implemented the better the chances are of a successful rescue. The management of the company may be more inclined to seek help if they stand a chance of remaining in post. In contrast they may be deterred from seeking help if they know that they will be displaced by an outsider coming in to take control of the firm. The debtor in possession model that has been adopted is not as extensive as under the United

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<sup>99</sup> 2006 Law, Article 73.

States Chapter 11 procedure, since the debtor will be supervised by an administrator, however it is a significant step forward nonetheless. Since debtor in possession proceedings have no precedent in China it may take some time before there is acceptance of proceedings whereby the managers who were in place during the company's downfall are able to stay in place during the reorganisation.

There is scope for continued state control over proceeding through the appointment of the administrator, since the liquidation panel, which is composed of officials from government authorities, can be nominated to occupy this role. This may be because currently there are still more than 2,000 debt-laden SOEs with no possibility of rehabilitation and the government intends to keep the process of bankruptcy of these enterprises completely under control. The position of administrator is also open to persons such as liquidators, lawyers, accountants or other professionals with requisite knowledge and qualifications in public agencies.<sup>100</sup>

Under the new law, the administrator need not be a natural person, therefore a legally established law firm, accounting firm or bankruptcy and liquidation firm can be appointed.

The involvement of an administrator can maximise the chances of a successful rescue, since the administrator may have experience of similar cases, and as an

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<sup>100</sup> The 2006 Law, Article 24.

outsider they may be able to identify weaknesses in the management or the business that can be addressed in the reorganisation proceedings. However, at least in the short term, there will be a shortage of experienced professionals and this could hamper the progress of the new law. An exception could be Shenzhen where a relatively sophisticated bankruptcy regime has been in operation, although experience of corporate rescue is limited even there. In Eastern Europe the expertise of insolvency professionals from mature systems was drawn upon and this is a model that it would be advisable for China to follow.

The administrator or, in debtor in possession proceedings, the debtor, must submit to the court and creditors' meeting a draft reorganisation plan within six months of reorganisation being ordered.<sup>101</sup> This timescale is relatively generous in comparison with those applicable under some other systems, such as the basic eight week timescale under the UK administration regime,<sup>102</sup> or the 120 day period in which a Chapter 11 debtor may exclusively file a plan in the US,<sup>103</sup> and there is provision for the period to be prolonged for another three months with the approval of the court if there is reasonable cause, such as in a complex case. Details of the duration of the plan are not specified. This is a matter that has been left for the market to

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<sup>101</sup> The 2006 Law, Article 79.

<sup>102</sup> IA 1986, Sch B1,49(5), inserted by the Enterprise Act 2002.

<sup>103</sup> 11 USC § 1121(b).

determine, as the duration will be determined by negotiation between the debtor and its creditors.<sup>104</sup> The reorganisation proceedings will be terminated upon the approval of the plan by the court.

Creditors who have submitted claims form part of a creditors' meeting and this meeting may select a creditors' committee to exercise supervisory powers in respect of the management of the debtor's estate.<sup>105</sup> At the meeting creditors will be grouped into four classes: secured creditors; claims to wages and various social and insurance claims; tax claims; and general unsecured creditors. The terms of the legislation would appear to enable bondholders to participate in the creditors' meeting, but not shareholders. The administrator can exercise managerial powers without having to report to the court and although he must report to the creditors' committee,<sup>106</sup> the committee has no powers to annul the actions of the administrator and it is unable to remove the administrator, that power being exercisable only by the court. The influence of the creditors' committee may

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<sup>104</sup> A reorganisation plan which has been approved by each class of creditors' meeting and then confirmed by the court will have binding effect on the debtor and all the creditors. See the 2006 Law, Articles 84 and 92.

<sup>105</sup> The creditors' representatives and an employee representative or a representative of workers. See article 67 of the 2006 Law.

<sup>106</sup> 2006 Law, Articles 68 and 69.

therefore be limited, which can strengthen state control over proceedings in cases where it is exercised.

Previously bankruptcy proceedings were subject to a requirement of local government approval, which is no longer the case under the new law, however, there may still be scope for regional political influence. The new law, as under the former law, provides that proceedings are to be heard in the place where the debtor is domiciled.<sup>107</sup> The proceedings could be distorted if local factors, such as the potential impact of the proceedings on local employment are taken into account. Although it is desirable for rescue proceedings to maximise the number of employees who are retained, if too many employees are kept on the chances of rescue could be badly hampered. In practice, local government has sought to maintain stability through interference with the decisions of local courts, which are unable to exercise their judicial power independently. In particular there is the potential for local protectionism which is detrimental to creditors' interests, particularly the creditors from other regions.<sup>108</sup>

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<sup>107</sup> 2006 Law, Article 3.

<sup>108</sup> For more details see S Cao, "The Legislation and Implementation of the Chinese Bankruptcy Law in the Past Ten Years" (1997) 57 *Study of Contemporary China* (in Chinese).



### **3. Balancing of interests of those affected by the proceedings**

Insolvency proceedings require difficult choices to be made regarding the allocation of a struggling company's assets. Several interest groups are affected: the company's creditors, both secured and unsecured; its managers; its shareholders; its employees; and the local community. Effective governance of proceedings entails a balancing of the interests of these groups. The allocation of entitlements of creditors in liquidation proceedings has been a particularly contentious aspect of the drafting process, as there has been some debate about the order in which creditors should be paid. Under Article 113 of the new law two separate sets of assets are established. One set consists of assets that are covered by security. The secured creditors are entitled to realise their claims from the proceeds of such assets. The other set of assets comprises the so-called bankruptcy estate which should be distributed among the remaining interest groups in the following order: respectively, expenses of the proceedings, employees' claims, tax claims and ordinary creditors' claims.

The debate that arose during the drafting process was as to the priority of secured claims and employment claims. Financial interest groups argued that the bankruptcy proceedings should not serve the function of the social security system.<sup>109</sup> On the

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<sup>109</sup> In mature insolvency systems the priority of secured credit is justified by reference to creditors having bargained to obtain priority; having offered sufficiently attractive terms to the debtor

other hand trade unions emphasised the important role of employees in the economy in the PRC: a fundamental principle of the Chinese Constitution is that the working class is the ruling class.<sup>110</sup> A compelling argument is that employees can least afford to lose what they are owed, which, in cases in which adequate social welfare provision is unavailable, explains their priority ahead of tax claims and the claims of trade creditors.<sup>111</sup> In light of the inadequate nature of the Chinese social security system at present it is arguable that greater provision might have been made, at least until such time as the system is improved.

#### **4. Governance of the proceedings**

A significant concern of creditors will be that the proceedings are governed fairly and that robust laws are available and applied to counteract fraudulent conduct prior to, and during, the proceedings. The appointment of the administrator potentially

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in exchange for this security; and having by registration given notice to other creditors of the presence of security: R Goode, "Is the Law Too Favourable to Secured Creditors?" (1983-4) 8 *Canadian Business Law Journal* 53 and for a more recent critical evaluations Finch, *supra* n 52, 452-9 and R Mokal, *Corporate Insolvency Law- Theory and Application* (Oxford University Press, 2005), Ch 5.

<sup>110</sup> Chinese Constitution 1982, article 1.

<sup>111</sup> In contrast, in systems where adequate social security provision is available, it is argued that employee priority is unnecessary: A Keay and P Walton, "The Preferential Debts Regime in Liquidation Law" (1999) 3 *The Company, Financial, and Insolvency Law Review* 84, 100.

serves to constrain and supervise the actions of directors. As noted above the directors may potentially stay in post during the proceedings, however there are restrictions on their conduct. Under Article 15 they are required to keep appropriately the company's property, books, documents and seals. They are required to exercise their power according to the requirements of court and administrator and to attend the creditors' meeting, answering any questions with honesty. Failure to attend the meeting without justifiable reason will lead to a fine. Similarly fines may be imposed if the books and accounts are not presented. In addition they may not leave their place of domicile without the permission of the people's court and they are prevented from taking up a position as a director, supervisor or member of senior management staff in other enterprises.

The creditors' committee provides an additional layer of governance that can serve a role in guarding against corruption.<sup>112</sup> The committee has roles in supervising the management and disposal of the debtor's assets and the distribution of the insolvent estate. It has a right to demand an explanation from the debtor or the administrator and it can require documentary evidence to be produced. There is a more limited supervisory role for shareholders in the enterprise, who are able to attend the creditors' meeting and discuss the draft reorganisation plan, but they are unable to vote.

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<sup>112</sup> The 2006 Law, article 68.

Some protection against wrongdoing is presented in the shape of provisions for the avoidance of transactions. In liquidation proceedings such laws may be characterised as maintaining and enforcing the system of entitlements to assets.<sup>113</sup> In rescue proceedings they serve to maximise the company's assets for use in the proceedings. Under these laws post bankruptcy payments of pre bankruptcy debts are invalidated, as is the collection, assessment or recovery of such debts, unless such payments could favour the reorganisation and benefit the debtor's assets.<sup>114</sup> The administrator or the debtor in possession may exercise powers for the avoidance of certain transactions entered into by the debtor prior to the commencement of the bankruptcy proceedings. The provisions contain the main types of avoidance provision that are found in insolvency systems worldwide: laws that target fraudulent transfers of property occurring within one year before the commencement of the insolvency proceedings and also unfairly preferential payments to individual creditor within six months prior to the commencement of insolvency proceedings where the debtor knew that making the payment would cause it to be unable to pay its debts and where the payment damages the interests

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<sup>113</sup> R Parry, *Transaction Avoidance in Insolvencies* (Oxford University Press, 2001), 17-26; Mokai, *supra* n 109, Ch 9.

<sup>114</sup> See Article 32 of the 2006 Law.

of other creditors.<sup>115</sup> The administrator is entitled to recover assets which have been illegally drawn and appropriated by directors, supervisors or senior management staff who have taken advantage of their position and power.<sup>116</sup> However the effectiveness of these laws may be undermined for the foreseeable future by weaknesses in the judicial system. This is a potential problem that must be addressed. In the event of the laws not being applied effectively, or being subject to corruption and interference, confidence in the insolvency system as a whole will be undermined and this may have a consequential negative impact on investment.

The law also includes measures that enable company managers to be brought to account. According to Article 125, the directors, supervisors or senior management staff who fail to discharge their duty faithfully and diligently, leading to the bankruptcy of the debtor enterprise, will incur personal civil liability.

Meanwhile, they will be disqualified from being director, supervisor or senior manager in any enterprise in the three years following the date on which the bankruptcy proceedings are terminated. These laws can contribute to the prevention of financial difficulties through the deterrence of wrongful behaviour, although again these effects will depend on adequate enforcement.

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<sup>115</sup> The 2006 Law, Articles 31 and 32.

<sup>116</sup> 2006 Law, Article 36.

The reorganization proceedings can be terminated in various circumstances. These include if the business and financial state of the debtor continues to deteriorate and there is no reasonable prospect that the debtor can be rescued.<sup>117</sup> They can also be terminated in various instances of wrongdoing, namely where the debtor acts fraudulently; causes an illicit reduction of assets; or engages in other behaviour that obviously infringes the interests of creditors. The proceedings may also be ended if the administrator cannot discharge his duties because of the debtor's conduct.

## **5. Implementation of a rescue plan**

The plan will be regarded as having been passed by each voting group if more than half of the creditors in that group that are present at the meeting give their approval, on condition that the value of claims of those creditors amounts to more than two thirds of the value of that group.<sup>118</sup> If the reorganisation plan has a direct impact on their investments, a special group of investors will be established outside the creditors' meeting to vote.<sup>119</sup> Although they may decline to approve the plan, in light of the relatively high thresholds for approval, the court enjoys cramdown powers and may approve the plan if the adjustment of the investors' rights is considered to

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<sup>117</sup> 2006 Law, Article 78.

<sup>118</sup> 2006 Law, Article 84.

<sup>119</sup> 2006 Law, Article 85.

be fair and justifiable.<sup>120</sup> A plan that fails to gain approval will result in the failure of the rescue attempt and the liquidation of the company.

It should be noted that the new law introduces DIP financing which could facilitate reorganizations by enabling the debtor to borrow money from banks and potential lenders by using its unencumbered assets to secure a post-petition loan.<sup>121</sup> If the new financing is used to pay the wages and social welfare claims of the employees during the period of continued trading, the finance provider will rank ahead of the existing creditors with the exception of other secured creditors.<sup>122</sup> In other words, this creditor does not obtain super-priority status ahead of all existing creditors in the order of distribution. As a result, although the new law gives the banks an incentive to lend to a financially distressed enterprise, this incentive is very limited, and this could be problematic. On the whole, the Chinese state banks are unwilling to advance loans to troubled firms. One survey indicates that, even in the ordinary course of business, nearly 90 per cent of medium and small sized enterprises face problems in raising funds from state banks in China, and so the prospects for

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<sup>120</sup> 2006 Law, Article 87.

<sup>121</sup> 2006 Law, Article 75 (2).

<sup>122</sup> 2006 Law, Article 42 (4); Weiguo Wang, *The Sum and Substance of Bankruptcy Law* (Law Press-China 2007), p124.

companies in financial difficulties will be extremely limited.<sup>123</sup> The introduction of super-priority financing to encourage banks and potential lenders to provide financial support for rescue attempts may be considered in future.<sup>124</sup>

In addition, a statutory moratorium takes effect in reorganisation proceedings to freeze creditors' rights of enforcement, so that the company may have breathing space to negotiate with creditors and draft the rescue plan. The period of the automatic stay starts from declaration of the court's order on granting the commencement of reorganisation and continues until the termination of the reorganisation proceedings. There is no fixed time limit on the period of moratorium. However a potentially significant weakness is that this moratorium does not cover the period from the petition for reorganisation being submitted to the petition being accepted and approved by the court. The prospects of a successful rescue could be damaged significantly if the company is not protected from the actions of creditors at this time of vulnerability.

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<sup>123</sup> This survey was made by Standard Chartered and Chinese Academy of Social Science in 2007 under the support of Chinese National Development and Reform Commission, and the involvement of more than 400 medium and small sized enterprises.

<sup>124</sup> J Shi, *supra* n 24, 645, 669.



From the perspective of judicial practice in the past eight months since the new law was implemented on June 1<sup>st</sup> 2007, it appears that the new law is not as yet being widely used. Although, the Supreme People's Court has not released official statistics publicly, some influential scholars have opined that the new law is not as effective and well running as they initially expected.<sup>125</sup> The inadequacies and legal uncertainties which have been analysed above may slow the progress of implementation. The Supreme People's Court has recently organized a special committee to produce a practicable judicial interpretation in order to flesh out the technical shortcomings of the new law and to resolve the problems which emerge in practice.

## **F. REMAINING CHALLENGES TO A SUCCESSFUL SYSTEM OF CORPORATE RESCUE LAWS IN CHINA**

In addition to the possible shortcomings of the law itself, there is still significant progress to be made in several areas, including as noted above the development of professional skills and experience by those who will be responsible for the practical operation of the law. The impact of the new law is likely to be delayed as a result. Further key challenges include those discussed below.

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<sup>125</sup> This information was expressed by Prof Shuguang Li, the drafter of the new law, on a forum hosted by the Bankruptcy Law Research Centre of China Renmin University and Beijing Weiheng Law Firm on August 27, 2007.

## I. Inadequate legal infrastructure

A lack of suitable governance structures to impose the rule of law can lead to bias in decision making, a failure to see through decisions that have been made, or more seriously corruption and a consequent loss of value in relation to businesses that undergo insolvency procedures.<sup>126</sup> Arguably the fact that China has one ruling party which, although subject to some supervision by eight democratic parties,<sup>127</sup> has the final say on any decision making should not necessarily stand in the way of economic prosperity. The example of Singapore, as a de facto one party state, is evidence that good economic governance can thrive in the absence of a two-party or multi-party political climate. However state interference in bankruptcy proceedings may continue with the judiciary as a conduit, since the judiciary are appointed by the government and the budget of the court is determined by the government. A trained and regulated system of insolvency professionals, supported by a judiciary independent of government interference is a minimum requirement. Preferably bankruptcy proceedings should be handled by specialist courts: currently they are

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<sup>126</sup> Tang, *supra* n 23, para 5.10

<sup>127</sup> Democratic parties are entitled to be involved in the legislation and policies of decision-making, to discuss domestic and foreign affairs, provide suggestions to the executive party and supervise the actions of Communist party. However the Communist party firmly has control over the final say in any decision-making. This is the so-called “democracy centralism” (*min zhu ji zhong zhi*).

dealt with by Second Civil Trial branches of local courts and intermediate courts.<sup>128</sup>

A level of experience in dealing with bankruptcy cases can only be developed over time and the courts hitherto will have been constrained by government influence, the newness of the legislation and the relatively limited number of bankruptcy cases that will have come their way, let alone cases involving the rescue procedures. In contrast the Intermediate People's Court of Shenzhen has operated a specialist bankruptcy division since 1993. During this time it has handled a high volume of cases and has developed streamlined procedures and policies.<sup>129</sup> This expertise can be drawn upon as the new bankruptcy law develops elsewhere, although it has been observed that the Shenzhen judiciary has failed to develop a sufficient culture of corporate rescue,<sup>130</sup> so that recourse may need to be had to experts from other countries or jurisdictions,<sup>131</sup> such as Hong Kong.

## **2. An inadequate social welfare system**

A significant challenge is presently presented by the weakness of the social safety net. An improved social security system was unveiled in a White Paper in 2002 but

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<sup>128</sup> Li, *supra* n 15; S Cao, "The legislation and Implementation of the Chinese Bankruptcy Law in the Past Ten Years" (1997) 57 *Study of Contemporary China* (in Chinese).

<sup>129</sup> Zhang and Booth, *supra* n 18, 8.

<sup>130</sup> Zhang and Booth, *supra* n 18, 24.

<sup>131</sup> Lan, *supra* n 28.

has been described as inadequate,<sup>132</sup> benefiting urban workers but not those in rural areas, who are regarded as capable of self sufficiency. The amounts paid are often inadequate in the face of rising prices, medical expenses and family commitments. If the new law has an immediate impact it could lead to an acceleration of job losses through the use of both liquidation and rescue, which would strain the system. Social unrest could arise if no suitable alternative employment opportunities were available and an insufficient living allowance was available.<sup>133</sup> This is perhaps the key reason why the law is unlikely to be allowed to reach its full effect immediately.

### **3. Pressures on the banking sector**

The new law can potentially bring about significant changes in the way in which non performing loans to SOEs are handled and it will test the effectiveness of the steps that have been taken to reform the banking sector. Such steps were not taken until relatively recently, most notably following the 1997 Asian financial crisis.<sup>134</sup> Asset

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<sup>132</sup> <http://www.china.org.cn/english/China/65204.htm> dated May 22 2003, accessed 29 January 2008.

<sup>133</sup> Chen, *supra* n 29, 42.

<sup>134</sup> For a discussion of these recent reforms see W Chen, "WTO: Time's Up for Chinese Banks: China's Banking Reform and Non-Performing Loan Disposal" (2006) 7 *Chicago Journal of International Law* 239.

management companies were established to acquire non performing loans from key banks in exchange for the issue of government backed bonds.<sup>135</sup> SOE restructuring was also employed to convert bad debts owed by failing enterprises into a fresh loan to a viable enterprise.<sup>136</sup>

The position of banks was also undermined by difficulties commonly encountered in the enforcement of security.<sup>137</sup> At the initial stage of transition from a planned economy to a market economy, the prospects of enforcement of security were particularly weak. First, there was no legislation on security interests until 1994 in which the first guarantee law was promulgated. Secondly, there was an intense debate on the attribution of state-owned assets as to whether they were still owned by the state or should belong to the enterprise. Although under the principle of

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<sup>135</sup> The AMC's were modelled on the United States Resolution Trust Corporation that had been deployed to liquidate assets of savings and loan companies declared insolvent by the Office of Thrift Supervision.

<sup>136</sup> Hiving off the profitable elements of the SOE to a newly formed company, to which the bank would make a fresh loan, which would then pass the sums received to the old company to discharge its debts to the bank. This seemingly circular process enables the bank to convert an old non performing debt owed by an unprofitable company into a debt owed by a viable entity, which stands a greater chance of repaying what is owed. Moreover repayment of the old company's debts is achieved ahead of other creditors. See the comments of Booth, *supra* n 34, 23-24.

<sup>137</sup> Booth, *supra* n 34, 23.

separate corporate personality, the assets which are authorised to the SOEs are clearly the property of the enterprises themselves and these enterprises will assume liabilities by using these assets independently. Currently, however, enforcement against state-owned assets is severely restricted and controlled under the supervision of specific government authorities. Thirdly, the state owned banks did not have the incentive to enforce their security, because such enforcement would be metaphorically like money passing from the left pocket to right pocket.

The ability of creditors to take security can lead to credit becoming available that would not otherwise be forthcoming, or becoming available at a lower price than would otherwise be the case. China has paved the way for creditors with reforms to its system of security interests however the package of benefits that are presented to the holder of such security do not reach the level enjoyed by creditors in many other jurisdictions. The benefits brought by the availability of secured credit will be reduced, or even lost, if there is uncertainty regarding the enforceability of this security, in particular whether the assets that it covers can be used to pay other debts, such as the wages of employees. The concessions made to secured creditors in relation to the order of payment in liquidation indicate a fresh willingness to recognise and uphold their entitlements.

Most recently the position of the state owned banks looks to be significantly strengthened through overseas listings, and the injection of capital as a result is timely. Not only will the new bankruptcy law potentially bring the scale of the problem of bad debts to light but also the banks will be exposed to foreign competition as the banking market opened up from December 11 2006, under WTO obligations, albeit subject to restrictions.<sup>138</sup> The banks will be exposed to the risk of their clientele transferring their deposits to fresh competitors and such a move would weaken the deposit base that has shielded the banks from collapse in the face of bad debts.<sup>139</sup>

#### **4. Development of corporate governance structures<sup>140</sup>**

Effective corporate governance is essential as a means of prevention of financial difficulties in companies. It minimises the potential for financial difficulties to be caused by agency costs generated by the separation of ownership and control, such

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<sup>138</sup> Lubman, *supra* n 63, 26.

<sup>139</sup> Lardy, *supra* n 7, 125 notes that the intervention of foreign banks was a key factor in the establishment of a competitive banking sector in Hungary.

<sup>140</sup> See CA Schipani and J Liu, "Corporate Governance in China: Then and Now" [2002] *Columbia Business Law Review* 1; Miles and Zhang, *supra* n 42, 213; and S Tenev, C Zhang and L Brefort, *Corporate Governance and Enterprise Reform in China: Building the Institutions of Modern Markets* (Washington DC, the World Bank and International Finance Corporation, 2002).

as slack management, or corruption. High profile examples from western countries indicate that poor corporate governance controls lie at the heart of many significant insolvencies.<sup>141</sup> There have been significant failings in this area in China, however more recently the corporation law was revised and successfully passed in the deliberation of the Standing Committee of the NPC in 2005. This revised law has been in force since 1st January 2006. It improves the corporate governance structure, strengthens duties and personal liabilities of directors and managers, and particularly emphasizes the protection of small shareholders. It appears to be a much more suitable and practicable law than the law it replaced, which was outdated.<sup>142</sup> Anecdotal reports suggest that it is effective and that the safeguards against misconduct are consequently strengthened. The effective operation of the corporate rescue procedures will also depend on existing notorious inadequacies in relation to accounting information being resolved. China has made significant strides in this regard, at least on paper.<sup>143</sup>

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<sup>141</sup> The Zhengzhou Baiwen case is ample evidence that weaknesses in corporate governance can lead to spectacular losses for creditors and investors in China. The case is discussed in X Wei, "People's Republic of China: the Legal Features of Chinese Capital Market in the Light of Zhengzhou Baiwen Case" (2002) 23 *Company Lawyer* 100.

<sup>142</sup> For more details see S Zhou, *New Survey On Corporation Law* (Beijing, Law Press-China, 2006) (in Chinese).

<sup>143</sup> For a survey see Deloitte, *Comparison between PRC GAAP and IFRS*

<http://www.iasplus.com/dttpubs/2005ifrsprc.pdf> dated 1 April 2005, accessed 29 January 2008.



## **5. Continued state intervention**

The potential for continued state involvement in the new corporate rescue procedures has been noted above. SOEs have gained benefits in the form, for example, of finance from state banks and monopoly protection. However involvement in state aids may infringe China's obligations under GATT, Article XVII and in acceding to the WTO China agreed that SOEs would make purchases and sales on a purely commercial basis and that those enterprises from other WTO member states would have a fair chance to compete. Paradoxically this development could be strongly to the long term benefit of the Chinese economy. Competition law not only rewards the fittest competitors and forces weaker competitors to reform or leave the market but it also acts as an important governance mechanism that minimises agency costs. A lack of a rigorous approach to state aids for firms in difficulty or whole industrial sectors in difficulty may address a short term need but it can be damaging to the economy in the long term. State intervention can cushion a struggling firm from the effects of the market, leading to inefficiencies. Firms which are not viable can continue, when they would otherwise be subject to insolvency proceedings. Where the state has bailed out a company in the past, or has otherwise intervened to save it from financial difficulties, this may

lead to an expectation of similar salvage in future.<sup>144</sup> In addition, where state assistance takes the form of economic aid there is a drain on the public purse. In the long term it would be advisable for China to heed the jurisprudence of the European Union that such aid should be temporary, limited to what is necessary in order to facilitate reorganization, and should be a one off event, so that companies do not have the expectation that they will be bailed out again should their problems recur.<sup>145</sup>

## G. CONCLUSION

The key social role that SOEs have played, and the potentially devastating effects on the workforce in particular regions that might be felt if the availability of corporate rescue, and particularly liquidation, proceedings were opened up, hitherto delayed the revision of the insolvency laws. These problems remain and social impact of the new law is potentially great on paper, presenting the prospect of large scale redundancies, both through liquidations and through restructuring in the context of

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<sup>144</sup> See the discussion of these problems in a different context by S Colazingari and S Rose-Ackerman, "Corruption in a Paternalistic Democracy: Lessons from Italy for Latin America" (1998) 113 *Political Science Quarterly* 447, 449.

<sup>145</sup> In the European Union the provision of state aids to struggling companies must fall within the Community Guidelines on State Aid for Rescue and Restructuring Firms in Difficulty OJ, C 244, 1 October 2004, p. 2.

corporate rescue procedures. Such redundancies would strain the presently inadequate social safety net, leading to a prospect of social unrest which was previously kept at bay through manipulation by the state. Although the problems are not as potentially great as they once were, owing to the implementation of gradual reforms in key areas over a number of years, it is clear that they remain a threat. The timescale for the implementation of the new law does not allow much opportunity for further developments in these areas. Potentially therefore the new law could have devastating social consequences. However the prospects of the new law reaching its full impact soon after its introduction are likely to be significantly limited by the court system, which may be subject to government influence; the inexperience of the court system in this area; the lack of accurate accounting information; and also a lack of cultural awareness of corporate rescue procedures.<sup>146</sup> In addition a significant skills gap is likely to be present for some time, since the operation of a system of corporate insolvency laws requires the involvement of trained and experienced accountants, insolvency professionals, asset valuers and judges with an understanding of the complexities of rescue proceedings.<sup>147</sup> Moreover there are many points of detail that are not addressed under the legislation and that will need to be fleshed out through judicial guidance

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<sup>146</sup> Alan CW Tang, *supra* n 23, paras 5.10--5.15.

<sup>147</sup> X Lan, *supra* n 28.

and by professional experience. Further revisions of the law may be necessitated as a result.