

New Issues in Chinese Enterprise Bankruptcy Law

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On August, 27, 2006, China promulgated the Law of the People's Republic of China on Enterprise Bankruptcy (hereafter referred as 'new Chinese Enterprise Bankruptcy Law'), which came into force on June, 1, 2007. The Law of the People's Republic of China on Enterprise Bankruptcy (for Trial Implementation) (hereafter referred as 'old Chinese bankruptcy law') was abolished simultaneously.

With the implementation of this new Chinese Enterprise Bankruptcy Law, important changes have been made to improve the bankruptcy legal systems of the past, such as extending the law's scope of application and strengthening the role of creditors' meeting. Meanwhile, some new ideas have been introduced, for instance, bankruptcy restructuring and the role of bankruptcy administrators.

In this paper, I will mainly discuss the application scope, the bankruptcy administrator and bankrupt restructuring, being the primary highlights in new Chinese Enterprise Bankruptcy Law.

1. Application Scope

As is provided in article 2 of new Chinese Enterprise Bankruptcy Law, enterprises that fail to pay their due debts and who do not have sufficient assets to pay off all their debts or are obviously incapable of clearing off their debts will fall within the scope of this law.

Without application of the bankruptcy law to individual, it has been criticized that only enterprises can go bankrupt according to the new Chinese Enterprise Bankruptcy Law. Furthermore, the procedures applicable to financial institutions (commercial banks, securities companies or insurance undertakings), will be quite different from the normal bankruptcy cases.

1.1 Why No Personal Bankruptcy?

It was suggested that the new Chinese Enterprise Bankruptcy Law included personal bankruptcy but, after a long discussion, this idea was not pursued. The main reason is that without other necessary supporting facilities on the market, it is impossible to implement personal bankruptcy in the P.R.C..

In P.R.C., the credit system is lagging behind more developed economies. The lack of public registry system of private wealth makes it impossible or fairly difficult to estimate the amount of private assets, a vital element for the operation of personal bankruptcy. It is feared that without effective credit system,

personal bankruptcy would become a method to escape from normal debts,¹ generating negative effect on the economy.

In addition, the social security system in P.R.C. is unsatisfactory, making personal bankruptcy unworkable. If an individual in the PRC were to go bankrupt, it would be necessary for him to get sufficient assistance from the social security system to maintain his basic life or there would be an unimaginable predicament for the individual and even serious problem for the whole society.

Realizing the importance of an efficient and comprehensive credit system for the implementation of personal bankruptcy, the relative immaturity of the credit and social security system in P.R.C. makes the operation of personal bankruptcy impracticable at present.

1.2 Bankruptcy of Financial Institutions

Due to its special character and extraordinary importance to the whole country, the bankruptcy of financial institutions (commercial banks, securities companies or insurance undertakings) is always a sensitive topic, demanding more caution. Article 134 of new Chinese Enterprise Bankruptcy Law was the only legal basis for this issue in P.R.C. until now, only providing a simple outline for complex legal issues. Without detailed information concerning practical operation, this article makes the following points:

Firstly, financial institutions can be the subject of a bankruptcy, which is somewhat a revolution in P.R.C.. In the past, nobody could imagine that a bank or other similar financial institutions would go bankrupt. Closely connected with people's daily lives, financial institutions have been strongly supported and deeply supervised by the government and would never be allowed to go bankrupt according to general point of view.

Secondly, different from normal bankruptcy, the applicant for the financial institution's bankruptcy is not the debtor (the distressed enterprise) or a creditor of the distressed enterprise², but the financial supervisory organ under the State Council, which has a high involvement during the financial institution's bankruptcy process.

¹ http://news.xinhuanet.com/legal/2005-06/29/content_3150331.htm, visiting date: 2008-08-14.

² Proper applicants of bankruptcy, see article 7 of new Chinese Enterprise Bankruptcy Law. Article 7 Where a debtor is under the circumstance as prescribed by Article 2 of the present Law, it may file an application with the people's court for bankruptcy restructuring, compromise or bankrupt liquidation. Where the debtor fails to pay off its due debts, it may file an application with the people's court for bankruptcy restructuring or bankruptcy liquidation. Where an enterprise legal person has been dissolved without any liquidation or without completing the liquidation and if the relevant assets are not enough to clear off the debts, the person liable for liquidation shall apply with the people's court for bankrupt liquidation.

Thirdly, detailed rules for the bankruptcy of financial institutions will be formulated by State Council in the future.³ It is a fact that citizens in China still tend to deposit money in banks as a secure way to keep savings. If a bank goes to bankrupt, how to protect depositor's benefits to the largest extent will be a headache for the legislator, which is still left blank until now. So, despite the fact that financial institution can go bankruptcy, how to deal with this issue in reality needs to be clarified by the State Council in the future.

2. Bankruptcy Administrator

2.1 Background

The bankruptcy administrator is the person who takes over and manages the assets of the debtor after the court has accepted the bankruptcy application.⁴ The concept of bankruptcy administrator was first formally introduced to P.R.C. by new Chinese Enterprise Bankruptcy Law.

2.2 The Liquidation Team in the Past

In the old Chinese Enterprise Bankruptcy Law, the liquidation team acted as bankruptcy administrator and took responsibility for the distressed enterprise's affairs during the bankruptcy process.⁵

³ Article 134 of Chinese Enterprise Bankruptcy Law:

Where such financial institutions as a commercial bank, securities company or insurance company is under any of the following circumstances as prescribed in Article 2 of the present Law, the financial supervision organ under the State Council shall file an application with the people's court for bankruptcy restructuring or bankruptcy liquidation of the financial institution.

Where the financial supervision organ under the State Council adopts such measures as take-over and custody to financial institutions with major business risks, it may apply with the court for suspending the procedures for civil action or execution, wherein the said financial institution is the defendant or party against whom a judgment or order is being executed.

Where a financial institution is under bankruptcy, the State Council may, according to the present Law and other relevant laws, formulate the corresponding measures for implementation.

⁴ <http://www.chinacourt.org/html/article/200407/30/125507.shtml>, visiting date: 2008-08-16.

⁵ See article 24 of the old bankruptcy law.

The people's court shall, within 15 days after the date the enterprise is declared bankrupt, establish a liquidation team to take over the bankrupt enterprise. The liquidation team shall be responsible for the keeping, putting into order, appraisal, disposition of distribution of the bankruptcy property. The liquidation team may carry out necessary civil actions in accordance with law.

The members of the liquidation team shall be designated by the people' court from among the superior departments in charge, government financial departments, and other relevant departments and professional personnel. The liquidation team may hire necessary personnel.

The liquidation team is responsible to, and shall make a report on its work to, the people's court.

The main criticism of the liquidation team was its composition. According to article 24 of the old Chinese Enterprise Bankruptcy Law, the members of the liquidation team were chosen by the court from among the personnel of the superior governmental departments in charge, governmental financial departments, and other relevant departments and professional personnel. In practice, the liquidation team would be mainly composed of governmental officials. Without professionals participating, the liquidation team could not fulfill its functions. On the one hand, bankruptcy liquidation is a highly complex task, demanding professional knowledge and skills. On the other hand, governmental officials are not professionals in liquidation affairs and have their own appointed tasks, making the liquidation team incapable of completing their anticipated functions.

2.3 The Bankruptcy Administrator under the new Chinese Enterprise Bankruptcy law

To solve this problem, the new bankruptcy administrator system has been set up to replace the old liquidation team.

2.3.1 When Getting Involved?

According to Article 13 of new Chinese Enterprise Bankruptcy Law, when the court accepts a bankruptcy application, it shall designate a bankruptcy administrator, whose duty terminates after the completion of write-off registration, unless the relevant action or arbitration has not been concluded.⁶ Therefore, the participation of the bankruptcy administrator in all aspects of the bankruptcy process makes it possible for the bankruptcy administrator to fully exert its functions.

2.3.2 Who Can be Appointed as Bankruptcy Administrator?

In new Chinese Enterprise Bankruptcy Law, the requirements for admission as a bankruptcy administrator are laid down in article 24, including both positive and negative criteria. Positively, a bankruptcy administrator may be a member of social intermediary agencies such as law firms, accounting firms, or bankruptcy liquidation firms. Negatively, the following people can not be designated as bankruptcy administrator:

- (1) Having been given a criminal punishment for deliberate crime;
- (2) Having been deprived of the relevant practice qualification;
- (3) Having any conflict of interest related to the case; or
- (4) Being under any other circumstance where the people's court deems it improper to act as a bankruptcy administrator.

In summary, bankruptcy administrators shall be those professionals with good fate and independence. In comparison with the liquidation team made of governmental officials, the bankruptcy administrator now is more advantageous in terms of professionalism and independence.

⁶ Article 122 of new Chinese Enterprise Bankruptcy Law.

2.3.3 Designated by Whom?

As is provided in article 24 of new Chinese Enterprise Bankruptcy Law, the court will designate a bankruptcy administrator, although this still incurs much criticism despite many positive effects, like higher efficiency and fewer disputes. It is widely accepted that when an enterprise goes to bankruptcy, one important issue is how to protect the creditors' interests to the largest extent, while accepting that their obligations to the debtor may be negatively affected due to debtor's bankruptcy. Realizing this, it can be easily understood why the designation of a bankruptcy administrator draws so much criticism from creditors. In some countries, like the US, Canada and Switzerland, a bankruptcy administrator will be appointed by the creditors.⁷ Where the bankruptcy administrator is appointed by the court, in countries such as Japan, Spain and France, this is criticized by many scholars in P.R.C. for the following reasons:

Firstly, it is more likely to protect the creditors' interests if the bankruptcy administrator is appointed by the creditors.

Secondly, if the bankruptcy administrator is appointed by the court, all the relevant actions undertaken by the bankruptcy administrator including detailed commercial arrangements will be reported to the court. The court is not expert on commercial affairs and its participation in commercial arrangements will conflict with its public role. Basically speaking, bankruptcy law is a private law and the parties' autonomy of will shall be respected at first hand. The court can only exert controlling power on legal procedures.

Personally, I believe that it would be better if the bankruptcy administrator were to be chosen by the creditors and the court reserved the final power of judgment to resolve any disputes arising from the bankruptcy administrator's appointment. In this way, the creditors' interests could be best protected and the court's independence.

2.3.4 Bankruptcy Administrator's Responsibility Insurance

To protect the bankruptcy administrator against disproportional liabilities originated from their performance, it is legally required that when an individual assumes the post of a bankruptcy administrator, he shall purchase professional liability insurance⁸, a totally new concept in P.R.C.. Although it is a perfect solution to the unpredictable responsibility placed upon the bankruptcy administrator, it is also helpful to the development of bankruptcy administration as a profession. So far, there is not yet such insurance available in P.R.C., forming a challenge for the insurance industry.

⁷ Li Shenghui: <Discussion on the designation rule as for bankruptcy administrator >, Hu Nan Journal Social Sciences Edition, March, 2006,

http://www.btophr.com/lawyer/m_up_view.ASP?id=10726&whoid=327588, visiting date: 2008-9-4.

⁸ Article 24 of new Chinese Enterprise Bankruptcy Law.

Moreover, since most bankruptcy administrators are lawyers or accountants, and already have their own professional liability insurance, it is feared by some scholars that the professional liability insurance for bankruptcy administrator will overlap with their existing professional insurance. Contrarily, in my view, the obligation of a person acting as a bankruptcy administrator is different from that of their original professions as lawyers or accountants. Since the original professional insurance coverage of lawyers and accountant will not extend to the risks from the bankruptcy process, there shall be no overlap. Besides, not all bankruptcy administrators are lawyers or accountants so insurance especially for bankruptcy administrators is necessary.

3. Bankruptcy Restructuring

3.1 Background

As the final renaissance chance for an enterprise in financial difficulty, bankruptcy restructuring is meaningful to protect distressed enterprises from liquidation. Although it has already been widely accepted in many jurisdictions, there was no such system in P.R.C. before the promulgation of the new Chinese Enterprise Bankruptcy Law. Despite a whole chapter, 25 articles have been devoted to regulating the bankruptcy restructuring procedure, there are still many points left unclear and waiting for further clarification by judicial interpretation.⁹

3.2 Which Situation?

In the following three circumstances, the debtor, the creditor or the capital contributor whose capital contribution makes up 1/10 or more of the debtor's registered capital (if the bankrupt liquidation is applied by the creditor against its debtor)¹⁰ may apply for bankruptcy restructuring with the court to be commenced:

1. The enterprise fails to be able to pay off its debts as due and its assets are not enough to pay off all the debts.
2. The enterprise is obviously incapable of clearing off its debts.
3. The enterprise is obviously likely to be unable to pay off its debts.¹¹

⁹ http://www.cs.com.cn/sylm/04/200803/t20080316_1399010.htm, visiting date: 2008-08-18.

¹⁰ Article 70 of new Chinese Enterprise Bankruptcy Law.

¹¹ Article 2 of new Chinese Enterprise Bankruptcy Law.

3.3 The Bankruptcy Restructuring Plan

Whether a bankruptcy restructuring can successfully avoid the final striking off and rescue the enterprise in issue largely depends on the contents of the bankruptcy restructuring plan and how it is to be enforced.

Who is the proper person to submit the bankruptcy restructuring plan? Since the debtor and bankruptcy administrator have the greatest knowledge of the financial and commercial situation of the enterprise in difficulty, they are required to submit a draft bankruptcy restructuring plan to the court within 6 months after the court's approval of bankruptcy restructuring,¹² depending on who actually takes charge of the assets and business operations of the debtor at that time.¹³

3.3.1 Voting on Bankruptcy Restructuring Plan

To fulfill its purpose to salvage the enterprise from financial difficulty, the bankruptcy restructuring plan is carried out through detailed arrangements with the creditors concerning the commercial and financial situation of the enterprise and the court shall not interfere too much. Generally speaking, the bankruptcy restructuring plan will be voted on by groups of creditors, divided according to their claims into:

- (1) The creditors with a security interest over particular assets of the debtor;
- (2) The wages, subsidies for medical treatment, disability and comfort and compensatory funds due by the debtor, the old-age insurance premiums, fundamental medical insurance premiums due by employers and compensation for employees as prescribed by the relevant laws and administrative regulations;
- (3) The taxes defaulted by the debtor; and
- (4) The ordinary creditors.¹⁴

If the draft bankruptcy restructuring plan adjusts the rights and interest of the capital contributors, a group of capital contributors shall be established to vote.

To clarify confusion and make it easier for the creditors to vote, the debtor or bankruptcy administrator shall give explanations for the draft of the bankruptcy restructuring plan and answer enquiries at the creditors' meeting. When 50% or more of the creditors in the same voting group agree to the draft of the bankruptcy restructuring plan, representing two thirds or more of the total amount of the creditor's right, the bankruptcy restructuring plan shall be deemed adopted.¹⁵

¹² Article 79 of new Chinese Enterprise Bankruptcy Law.

¹³ Article 80 of new Chinese Enterprise Bankruptcy Law.

¹⁴ Article 82 of new Chinese Enterprise Bankruptcy Law.

¹⁵ Article 84 of new Chinese Enterprise Bankruptcy Law.

However, if a voting group disagrees even upon re-voting, the relevant debtor or bankruptcy administrator may apply with the court for approval of the bankruptcy restructuring plan if the following requirements are met:

Firstly, the bankruptcy restructuring plan can pay the creditors and relevant losses.

Secondly, the repayment proportion of the ordinary creditors shall not be lower than they would get in a bankrupt liquidation.

Thirdly, the bankruptcy restructuring plan can bring a fair and justifiable adjustment to the rights and interests of capital contributors, or the contributor group has adopted the bankruptcy restructuring plan.

Fourthly, the bankruptcy restructuring plan treats the members of a same voting group fairly.

Finally, the debtor's business plan is feasible.¹⁶

As long as the court deems that the draft of bankruptcy restructuring plan complies with the above requirements, it shall approve it within 30 days.

Despite the detailed legal criteria mentioned above, in practice, it is not easy for the court to decide whether to approve the bankruptcy restructuring plan or not, especially when it has already been declined by at least one voting group of creditors. From the judicially neutral standpoint, it is unrealistic for the court to step into the shoes of the merchant to value the bankruptcy restructuring plan according to commercial standards. As a result, the court can only judge the bankruptcy restructuring plan from the aspect of basic debtor-creditor legal relationships, checking whether the creditors can be reasonably protected.

3.3.2 Enforcement of Bankruptcy Restructuring Plan

After the restructuring plan has been approved by the court, the whole plan will be implemented by the debtor. To enable the debtor to enforce the bankruptcy restructuring plan, the bankruptcy administrator shall transfer the assets and business operation back to the debtor.¹⁷ A debtor may, upon filing an application and obtaining an approval from the court, manage its assets and business operation under the supervision of the bankruptcy administrator.¹⁸ Furthermore, the enforcement of securities rights over the debtor's assets will be suspended, except in the case of possible damages or significant depreciation of value, which may injure the guarantor's right. In this case, the debtor or bankruptcy administrator can provide security on the loan to enable the business to keep running.¹⁹ To sum up, great freedom will be

¹⁶ Article 87 of new Chinese Enterprise Bankruptcy Law.

¹⁷ Article 89 of new Chinese Enterprise Bankruptcy Law.

¹⁸ Article 73 of new Chinese Enterprise Bankruptcy Law.

¹⁹ Article 75 of new Chinese Enterprise Bankruptcy Law.

granted to the debtor to facilitate the bankruptcy restructuring. Meanwhile, the bankruptcy administrator will supervise implementation of the restructuring plan and the debtor shall report to the bankruptcy administrator on the enforcement and its financial status.²⁰

3.3.3 Result of Bankruptcy Restructuring

If the bankruptcy restructuring plan has been successfully implemented, the relevant debtor is not required to make repayment for the balance of the liabilities that have been reduced according to the bankruptcy restructuring plan.²¹ The enterprise will be saved from cancellation and go back to normal business again.

If the debtor fails or refuses to implement a bankruptcy restructuring plan, upon request of the bankruptcy administrator or other interested parties, the court may terminate the implementation of the bankruptcy restructuring plan and announce the debtor bankrupt, leading to cancellation of the enterprise in the end.

4. Final Words

The new Chinese Enterprise Bankruptcy Law has been implemented for around one year, bringing many positive changes to the bankruptcy system in P.R.C..

According to statistics, in 2007, only 3817 bankruptcy cases have been accepted by the courts in P.R.C..²² Such small amount is abnormal in comparison to the size of the economy. There are three main explanations for this phenomenon:

Firstly, without individual bankruptcy in P.R.C., only enterprises can go bankrupt, making the number of bankruptcy cases pretty small.

Secondly, due to lack of corresponding sanctions and liabilities, many distressed enterprises still exit the market without undergoing proper legal bankruptcy procedures.

Thirdly, some courts are not confident of their ability to deal with complicated bankruptcy disputes and tend not to accept bankruptcy applications.

As has been summarized by Xi Xiaoming, vice president of the Supreme Court in P.R.C. , the main challenges for bankruptcy law nowadays are:²³

On the first hand, unclear jurisdiction of bankruptcy cases has to be resolved. Since bankruptcy cases are more complex than normal cases and need more professional knowledge, personally, I believe that

²⁰ Article 90 of new Chinese Enterprise Bankruptcy Law.

²¹ Article 94 of new Chinese Enterprise Bankruptcy Law.

²² <http://service.smeshx.gov.cn/lf%5C202648904.htm>, visiting date: 2008-08-22.

²³ <http://service.smeshx.gov.cn/lf%5C202648904.htm>, visiting date: 2008-08-21.

considering the special needs of bankruptcy, reliance on the grassroots court system²⁴ is not suitable to deal with bankruptcy cases.

On the second hand, how to effectively operate the bankruptcy administrator system remains a big question for P.R.C.. As a new arrangement in the bankruptcy law in P.R.C., there are numerous points waiting to be clarified to make it more feasible in real life. Judicial interpretations by the Supreme Court on the designation of the bankruptcy administrators and their proper payment came out in April, 2007 to facilitate the operation of bankruptcy administration in legal practice.²⁵

On the third hand, the most complicated bankruptcy cases are bankruptcies of state-owned enterprises, listed and securities companies, because of the difficulties with the employees and historical problems, protecting the investors' interests on the stock market and distinguishing the assets of the securities companies from those belonging to the clients.²⁶

All these questions are hopefully to be solved by judicial interpretations. But in my view, to improve the bankruptcy system in the P.R.C., comprehensive and fine legislation is one thing, another important thing is how to improve the correspondent credit system, registration system and people's consciousness concerning bankruptcy. Only a matching social environment with proper auxiliary equipment can make the law work well.

²⁴ In P.R.C., there exist several levels of courts, grassroots court, intermediate court, high court and supreme court.

²⁵ http://news.xinhuanet.com/legal/2007-04/17/content_5987397.htm,
http://news.xinhuanet.com/legal/2007-04/16/content_5984996.htm, visiting date: 2008-9-4.

²⁶ http://news.xinhuanet.com/legal/2008-03/11/content_7766012.htm, visiting date: 2008-08-20.