

Policy-Oriented vs. Market-Oriented Bankruptcy: A Tour on the PRC New Enterprise Bankruptcy Law

By Will Fung¹

Historically, the Chinese legal system has never formally recognized the concept of bankruptcy. “*Debts incurred by the father shall be assumed by the son*” has been a cultural tradition passed down from generation to generation. The first attempt to create bankruptcy laws took place in 1906 during the late Qing Dynasty. However, these laws proved too difficult to implement² and were annulled two years later. From that unimpressive beginning, bankruptcy law never really took hold in China.

For decades thereafter, the Chinese government did not have any concrete insolvency laws in place, particularly after establishment of the People’s Republic of China in 1949. The Chinese government used a system whereby State-owned enterprises would have any losses offset by subsidization by the State. This meant that bankruptcy was never an issue. If, however, the State-owned enterprises were in serious financial difficulties, either they would be closed, suspended or consolidated or the business model would be changed. Bankruptcy, it seemed, would occur without any legal recourse and nothing would be due or owing to the creditors.³

The “Old” Bankruptcy Law

The 1986 Enterprise Bankruptcy Law of the People’s Republic of China, promulgated on December 2, 1986 and effective on October 1, 1988 (the “1986 Enterprise Bankruptcy Law”, also known as the “Old” Bankruptcy Law), was the first significant attempt at bankruptcy reform in China since the Qing dynasty. However, the 1986 Enterprise Bankruptcy Law was not viewed as adequately effective in regulating bankruptcy issues and was to a general extent applicable only to State-owned enterprises. As a result, a large number of State-owned enterprises incurred significant losses, but had their debts and loans written off by State-controlled banks.

There were additional problems with the 1986 Enterprise Bankruptcy Law. It allowed significant discretion by the administrative authorities in the bankruptcy process. Under that law, State-owned enterprises required government approval before bankruptcy could occur. This was because employees and existing assets needed to be resettled before bankruptcy would be considered.⁴ As a result, only “leftovers” were paid to creditors, which meant creditors had few rights and remedies in the bankruptcy process. The issue was further plagued by the long tradition of “identity” and “instability”, as State employees or the so-called government servants (to the outside world) were guaranteed an “*iron rice bowl*” or life-time employment.⁵

Other insolvency laws were also enacted in China over this period supplementing the 1986 Enterprise Bankruptcy Law. In April 1991 (at the fourth Session of the Seventh National

¹ The author wishes to acknowledge the contribution by his research intern in the firm, Steven Kuo, a LL.B (Hons) Graduate from the University of Westminster, UK.

² Li Shuguang, Bankruptcy Law in China: Lessons of the Past Twelve Years, Harvard Asia Quarterly (9/4/06).

³ *Ibid.*

⁴ Lan Xinzheng, Outdated Bankruptcy law Upgraded, [China Submits New Drafts of Bankruptcy Law to Facilitate Move Toward a Full Market Economy](#), The Beijing Review.

⁵ Li Shuguang, *op. cit.*, p. 2.

People's Congress ("NPC")), the NPC issued the amended 19th Chapter of the Code of Civil Procedure (the "Civil Procedure Law"), which enacted a procedure for bankruptcy repayment of enterprises as legal persons. Articles 199-206 discussed bankruptcy for non-state-owned enterprises⁶, specified repayment procedures (Art. 199) and provided a three-month period for creditors to file claims in the People's Courts (Art. 200). Art. 204 established priorities for repayments: (1) wages of employees and labour insurances, (2) unpaid taxes, and (3) finally, bankruptcy claims.

Despite the grant of these legal rights to creditors in the Civil Procedure Law, heavy intervention from government departments impeded the effectiveness of the courts, and creditors rights were not upheld in equity. Even though the law provided for a 3-month time period for claims, a claim would be deemed abandoned if the creditor was unable to notify the courts in time⁷.

There were also issues of interpretation. For example in the Civil Procedure Law the instrument used to identify rights between parties is the use of "judgment" or "panjue" and of "ruling" or "caiding". These methods are often confused with bankruptcy law and deprive parties the right to challenge evidence and appeal.

Other problems under that regime persisted. In some cases assets were distributed to local creditors but not creditors from other jurisdictions⁸. In other instances major creditors such as commercial banks had a significant influence in court proceedings, while smaller trade creditors were ignored or not even notified at all. Some judges lacked capacity and experience, especially in smaller, undeveloped cities, in comparison to bigger and more advanced cities, where judges had more experience in handling bankruptcy proceedings. The miscarriage of justice from even one incorrect judgment clearly damages the rule of law. However the problem cannot be solely based on incorrect judgments from the courts. Implementation of the poorly drafted old bankruptcy legislation was a major contributory factor for its failure.⁹

In *Liquidation Group of Wenzhou Trust Company v. Xinfu Industrial Co. Ltd.* (3/21/00), the Higher People's Court of Hubei Province, and on appeal the Supreme People's Court (7/18/02), demonstrated a need to protect creditors' rights. However, a year later, in 2003, the Higher People's Court of Guangdong Province, construed the 1986 Enterprise Bankruptcy Law strictly and placed the creditors' group as the lowest priority, resulting in minimal recovery for the creditors. This inconsistent approach adopted by the courts at different levels demonstrated the need for further bankruptcy reform.

Statistics

⁶ [Civil Procedure Law of the People's Republic of China](http://www.lawinfochina.com), promulgated April 9, 1991 and effective immediately (adopted at the 4th Session of the 7th National People's Congress) (<http://www.lawinfochina.com>).

⁷ Wang Xinxin, [On the Implementation and Perfection of China's Bankruptcy Law](#).

⁸ Professor Wang Weiguo (Dean, Department of Economics Law, China University of Politics and Law, Beijing, China), *Strengthening Judicial Expertise in Bankruptcy Proceedings in China – Judges' Predicaments in Bankruptcy Proceedings: Hardship in Keeping Equitable Treatment to Creditors*, Paper delivered in Forum for Asian Insolvency Reform, Bali – Indonesia, February 7-8, 2001.

⁹ Wang Xinxin, *op. cit.*, [Defects in Bankruptcy Law: Problems with the Judicial Interpretation by The People's Supreme Court](#).

From 1989 until 1994 only a few bankruptcy cases were filed. In 1989 the courts accepted 98 cases; in 1990, 32 cases; in 1991, 117 cases; and in 1992, 428 cases.¹⁰

In 1994 the government attempted to draft a new national bankruptcy law, despite concerns over unemployment. The first draft was completed in 1995. This was then redrafted in 1998 and numerous times subsequently, resulting in the draft of 2004¹¹, which formed the basis of the newly enacted Enterprise Bankruptcy Law discussed below.

Between 1994 and 2004, 3,484 state companies went bankrupt, with US\$28.5 billion in repayment debts, written-off by State-controlled banks. 1,828 State-owned enterprises still await approval for declaration of insolvency, amounting to US\$14.7 billion¹².

From a slow start in 1988, the number of bankruptcy cases steadily increased. More than 16,000 enterprises declared bankruptcy from 1988 to 2004. In 1994 only 395 of the total 1,624 bankrupt enterprises were State-owned. In 1997, approximately 3,060 of the 5,396 enterprises filing for bankruptcy protection were State-owned, while the remainder were private and Sino-foreign joint enterprises, indicating a mix of enterprises filing for bankruptcy.¹³

The 2006 Enterprise Bankruptcy Law

On August 27, 2006, with the adoption of a new Enterprise Bankruptcy Law in China, the attempt by the government to carefully shift bankruptcy towards a more market-oriented policy seems promising. The new law, which will take effect on June 1, 2007, has an expanded scope and includes legal corporate persons, encompassing not only State-owned enterprises, but also private and public companies, whether foreign or Chinese, and to a certain extent is applicable to financial institutions as well.

The new law also seeks to protect creditors' rights as well as workers' rights. The legislation not only allows creditors to take actions against debtors and companies that are unwilling to file for bankruptcy, it also limits State intervention in bankruptcies of State-owned companies. Another improvement is the ability of companies or enterprises in financial difficulty to reorganize, restructure and rectify their financial problems prior to filing for bankruptcy (Art. 73).

Previously, bankruptcy administrators were comprised of State-appointed personnel, leading to government interference in the bankruptcy process. The new law gives creditors the ability to participate in the selection of bankruptcy administrators. For instance, the role of bankruptcy administrator may be assumed by a liquidation group comprised of the relevant departments and organs or by intermediary agencies, and creditors may nominate a law firm, accounting firm, manager or receiver in accordance with law (Art. 24).

The 2006 Enterprise Bankruptcy Law will certainly boost investor confidence, particularly for foreign investors.

Conclusion

¹⁰ Charles Booth, *Drafting Bankruptcy Laws in Socialist Market Economies: [Recent Developments In China and Vietnam](#)*, p. 95.

¹¹ *Ibid.*, p. 96.

¹² Li Shi, *Push For Market-Oriented Bankruptcy*, China Daily (5/23/05).

¹³ Li Shuguang, *op. cit.*, p. 2.

This article examines some of the constructive changes made by the 2006 Enterprise Bankruptcy Law. The general perception of the new law is positive and welcoming. The relevant authorities are more than open to feedback to further enhance and improve the 2006 Enterprise Bankruptcy Law. The true test will come upon pronouncement of a series of implementation guidelines and bylaws under the new law. It is everyone's hope that these pronouncements do not render the new law a "toothless tiger".

Only time will tell. Experts and experienced professionals in handling liquidation processes must be engaged. The fee arrangement by creditors in appointing a bankruptcy administrator, private manager or receiver must be made independently and transparently, without interference by the courts except for verification of the qualification of such appointment. To discourage non-compliance by debtors with the instructions of a bankruptcy administrator, effective judicial recourse must be available in an expedited manner. Lastly, this author respectfully submits that the creation of a specialized court, or division within the People's Courts, to deal specifically with Enterprise Bankruptcy cases would vastly enhance the competency and transparency of the bankruptcy process.

This article was written and contributed by Will Fung, a Malaysian Advocate & Solicitor of the High Court of Malaya and currently acting as a Senior Foreign Legal Advisor to the law firm of Lehman, Lee & Xu, with offices in Beijing, Shanghai, Shenzhen, Hong Kong, Macau, Mongolia, and Chicago (correspondent office). Mr. Fung can be reached at wfung@lehmanlaw.com or (86) (10) 8532 1919.