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**Module 8B**

**Guidance Text**

**China (PRC)**

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## 1. INTRODUCTION TO INTERNATIONAL INSOLVENCY LAW IN THE PEOPLE'S REPUBLIC OF CHINA

Welcome to **Module 8B**, dealing with the insolvency system of **China (PRC)**. This Module is one of the elective module choices for the Foundation Certificate. The purpose of this guidance text is to provide:

- a general overview, including the background and history, of China's insolvency laws;
- a relatively detailed overview of China's insolvency system, dealing with both corporate and consumer insolvency; and
- a relatively detailed overview of the rules relating to international insolvency and how they are dealt with in the context of China.

This guidance text is all that is required to be consulted for the completion of the assessment for this module. You are not required to look beyond the guidance text for the answers to the assessment questions, although bonus marks will be awarded if you do refer to materials beyond this guidance text when submitting your assessment.

Please note that the formal assessment for this module must be submitted by **11 pm (23:00) BST on 31 July 2021**. Please consult the web pages for the Foundation Certificate in International Insolvency Law for both the assessment and the instructions for submitting the assessment. Please note that no extensions for the submission of assessments beyond 31 July 2021 will be considered.

For general guidance on what is expected of you on the course generally, and more specifically in respect of each module, please consult the course handbook which you will find on the web pages for the Foundation Certificate in International Insolvency Law on the INSOL International website.

## 2. AIMS AND OUTCOMES OF THIS MODULE

After having completed this module you should have a good understanding of the following aspects of insolvency law in China:

- the background and historical development of Chinese insolvency law;
- the various pieces of primary and secondary legislation governing Chinese insolvency law;
- the operation of the primary legislation in regard to liquidation and corporate rescue;
- the operation of the primary and other legislation in regard to corporate debtors;
- the rules of international insolvency law as they apply in China;
- the rules relating to the recognition of foreign judgments in China.

After having completed this module you should be able to:

- answer direct and multiple-choice type questions relating to the content of this module;
- be able to write an essay on any aspect of Chinese insolvency law; and
- be able to answer questions based on a set of facts relating to Chinese insolvency law.

Throughout the guidance text you will find a number of self-assessment questions. These are designed to assist you in ensuring that you understand the work being covered as you progress through text. In order to assist you further, the suggested answers to the self-assessment questions are provided to you in **Appendix A**.

### 3. AN INTRODUCTION TO CHINA

The People's Republic of China (commonly known as China) lies in the eastern part of Asia, sharing borders with many neighbours, notably Russia, Mongolia, India and Pakistan. It was once a great civilisation, excelling in its governance, arts and sciences. China's Confucius philosophy, which values virtue and justice and was developed two thousand years ago, still has great influence in East Asia and beyond.

However, from the middle of the 19<sup>th</sup> century China declined dramatically for a variety of reasons, including civil unrest, famines and military defeats. The republican revolution overthrew the last feudal dynasty, the Ch'ing Royal Court, in 1911. But the revolution failed to bring prosperity and peace; instead, it led to civil wars fought between the Republicans and Nationalists at first and later between the Republicans and the Communists (until 1949); in the end, the Soviet-backed Chinese Communist Party under Chairman Mao Zedong won the civil war and established the current People's Republic of China.

During the Chairman Mao era, between 1949 and 1976, China was under strict Communist control with the Soviet-style planned economy almost having destroyed China, both socially and economically. Following the death of Chairman Mao in 1976, the pragmatic reformer, Mr Deng Xiaoping, who succeeded Chairman Mao and was the *de facto* head of the China Communist Party until he died in 1997, opened China to the outside world and launched the successful economic reforms by emancipating Chinese people. Hereafter China's private economy thrived, which is the major drive of China's current economic success.

During the past three decades, under the self-styled socialist market economy, China has transformed itself from a land of poverty to a high- to middle-income country, with its GDP per capita reaching USD 16,600 (Purchasing Power Parity) in 2017. As the second largest economy in the world, it is fair to say that the majority of China's 1.38 billion people are the beneficiaries of its economic prosperity.

Although China has become richer, it is still an authoritarian one-party state, with the China Communist Party controlling all government agencies, including law courts. In certain circumstances, judges must seek guidance from senior Party officials when adjudicating sensitive cases, which undermines the integrity of China's judicial system. However, given the relatively small number of politically-sensitive cases, it is submitted that the biggest threat to the Chinese judicial system is allegations of corruption.

As for the political system, China is a rigid top-down hierarchy; the China Communist Party's Central Politburo, comprising seven members (including Mr Xi), sits at the top and decides the political appointments of all key positions at national level, such as the Prime Minister, the Cabinet Members, the Speaker of the People's Congress and of course the President of the China Supreme People's Court. The People's Congress, China's parliament, is reputed to be a rubber stamp, serving as a tool of the Communist Party to artificially create a mask of legitimacy.

At local level, the China Communist Party local committee has the same control over local governments, people's congresses and law courts. Senior Party officials not only control the appointment of local government agencies, including law court presidents, but are also reputed to interfere with the daily business affairs of these bodies.

Regarding the legal culture, greatly influenced by the Japanese and German legal systems, China is a civil law jurisdiction where judges rely solely on statutes, not precedents, to make judgments. However, most Chinese statutes are notorious for their ambiguity and vagueness, as a result of which judges tend to look at judicial notices issued by the China Supreme People's Court for detailed guidance. It is not an exaggeration to state that most of the legal rules in China are made by the China Supreme People's Court in the form of various judicial notices / opinions, largely because of the Court's own technical qualification and the practical needs arising from daily judicial work.

## **4. LEGAL SYSTEM AND INSTITUTIONAL FRAMEWORK**

### **4.1 Legal system**

#### **4.1.1 General**

In China, all statutes are made by the China People's Congress. However, there are two categories of statutes, depending on their legislative importance in the eyes of the Congress. The first category is fundamental statutes regulating essential relationships in the Chinese society, notably criminal and property law statutes; these statutes must be voted on by the China People's Congress General Meeting, which is held once a year. The second category relates to ordinary statutes, such as the enterprise bankruptcy Law, which are deemed less important and only need to be voted on and passed by the China People's Congress Standing Committee, which meets on a more regular basis. Whether a statute is considered fundamental or ordinary, it makes no difference when these statutes are cited in courts. For lawyers, all statutes have the same legal effect.

As noted above, most provisions of China's statutes are too simple or too ambiguous to be used in reality and many statutes are, as pointed out by many western scholars, more or less policy statements only; the Congress tends to avoid some difficult issues under pressure from vested interest groups so as to pass the law more quickly. This is inevitably done at the cost of clarity. But unlike the China People's Congress that can turn a blind eye to the daily life of businesses and individuals, law courts and judges face real disputes and real people and must provide real answers, so they need clearer rules to deal with litigation. The China Supreme People's Court fills this gap. Every year, the China Supreme People's Court drafts and releases many judicial notices guiding law courts and judges in handling litigation. Therefore, in general, judicial notices from the Supreme Court constitute a major source of rules on which judges rely. Understanding judicial notices made by the Supreme Court is key to practicing law in China.

The China State Council, the executive branch of the Chinese central government, also produces many regulations that serve as a great source of law in China. In theory, the State Council regulations are inferior to the statutes promulgated by the People's Congress, which means that in the event of a clash between them, the statute prevails. But, in reality, some regulations issued by the State Council either ignore the statutes or superficially comply with the letter of the statutes but violate their spirit. This is mainly due to the fact that, compared with the People's Congress, the China State Council is a far more powerful body in the Chinese political landscape. When faced with clashes between State Council regulations and Congress statutes, law courts are actually placed in a very difficult position; judges tend to skilfully avoid mentioning these conflicts in judgments but will be more likely to defer to the State Council regulations for instructions, mainly because of the weaker authority of the China People's Congress.

To add to the complexity of Chinese legal sources, many regulatory rules are made by the ministries under the China State Council. In principle, the ministry rules can only set up some detailed guidance on the implementation of some statutory provisions or of the State Council regulations, but in practice many ministry rules go much further. Given that there is no Constitutional Court in China and that Chinese courts are not allowed to check constitutional compliance by state organs, law courts and judges have to rely on a superior law when adjudicating cases. In reality, however, politics determines how judges choose which level of laws should be adhered to.

Apart from at national level where the aforementioned bodies can produce laws and rules in China, the provincial People's Congresses can also promulgate some regional laws that apply locally. But in reality, few lawyers read the rules made by provincial People's Congresses since the local rules are of insignificance for commercial transactions or criminal prosecutions.

Turning to bankruptcy law, up to now China still does not have a bankruptcy law for individuals, although in recent years the China Supreme People's Court has campaigned for the promulgation of a personal bankruptcy statute. This has been done with the support of some forward-looking bankruptcy scholars, notably Professors Wang Weiguo and Wang Xinxin. Currently, China only has a bankruptcy law for enterprises (including companies).

#### **4.1.2 Historical development of the bankruptcy laws**

Historically, China's first bankruptcy law can be traced back to the year 1906 when the last feudal dynasty under the Emperor Guang Xu promulgated the China Bankruptcy Law of 1906, which regulated the bankruptcy of both businesses and individuals and upheld the *pari passu* principle between unsecured claims. However, the 1906 bankruptcy law was abolished (in 1907) due to resistance from some business communities based on the allegation that, among other things, the law failed to distinguish the difference in ownership between family and individual. In revoking this law, the Royal Court planned to update the 1906 bankruptcy law and add it into the forthcoming commercial code in years to come but, unfortunately, the last feudal dynasty was toppled by the republican revolution in 1911. As a result, the initiative of updating the 1906 bankruptcy law was also dropped.

China was mired in civil wars after 1911. It was not until 1935 that the republican government passed the China Bankruptcy Law of 1935, in the middle of military conflicts with the Communist rebels. The 1935 bankruptcy law was acclaimed as a masterpiece of law integrating international norms with local custom and borrowed



many best practice from Germany, France and England. Like the 1906 law, the 1935 bankruptcy law also applied to both businesses and individuals and set up a court-centred bankruptcy system. Unfortunately, in 1949 the Republican / Nationalist government was again defeated by the Communists in the civil wars and fled to Taiwan Island. After taking power at national level, the revolutionary Communists abolished all legislation made by the previous government and inevitably the China Bankruptcy Law of 1935 was also on the abolition list. However, this law is still in force in Taiwan.

The triumphant Communists established their national government in 1949. Mainly due to the planned economy and the Communist ideology, Communist China (mainland China, which is to be distinguished from Taiwan Island, Hong Kong and Macau as special administrative zones of China) did not have a bankruptcy law until 1986, when the ruling Communist government realised the importance of a bankruptcy law in closing down inefficient state-owned enterprises (SOEs). In 1986 (and despite fierce opposition), backed by the then liberal Prime Minister Mr Zhao Ziyang, the China People's Congress passed the first China Enterprise Bankruptcy Law of 1986, which came into force on 1 November 1988.

The Enterprise Bankruptcy Law of 1986 only applies to SOEs, since the intent of the administration is to use this law to warn underperforming SOEs to operate more efficiently. China's economy and society recovered considerably following the death of Chairman Mao. Some rational lawmakers and leaders were soon aware that having a bankruptcy law only for SOEs is incomplete for establishing a comprehensive bankruptcy law system, since there were a growing number of private and foreign enterprises in China at the time, especially in the wake of the massive economic reforms championed by the pragmatic leader, Mr Deng Xiaoping. Therefore, when the China People's Congress drafted the China Civil Procedure Law in 1991, a chapter, Chapter 19, on bankruptcy for non-SOE enterprises was inserted. Hence, up to 1991 there were two pieces of legislation in force to regulate the bankruptcy of China's enterprises: the China Enterprise Bankruptcy Law of 1986 for SOEs and Chapter 19 of the China Civil Procedure Law of 1991 for non-SOE enterprises.

It is worth noting that both laws only allow enterprises having an independent legal status to use the formal bankruptcy procedure. This essentially meant that small businesses under the sole trader title could not access the court-involved bankruptcy regime. Currently in China around two-thirds of registered businesses are sole traders and these private traders are more or less treated as individuals, who are denied access to the formal bankruptcy system when they are in financial crisis.

During the 1990s China became increasingly more open and interacted more with international communities, culminating in China's eventual accession to the World Trade Organisation in 2001. As promised to the WTO partners, China started reforming its fragmented enterprise bankruptcy law in the late 1990s and the early 2000s, with a unified enterprise bankruptcy law, the China Enterprise Bankruptcy Law of 2006, enacted in 2006 and taking effect on 1 June 2007. The 2006 law combines the previous China Enterprise Bankruptcy Law of 1986 and Chapter 19 on bankruptcy of the China Civil Procedure Law of 1991. It goes without saying that more international best practice standards have been embraced by the 2006 law.

By Chinese standards, the China Enterprise Bankruptcy Law of 2006 is the first unified corporate bankruptcy statute, as it applies to both SOEs and non-SOE enterprises. Although Chinese lawmakers used the word "enterprise" in the law's name, given that the majority of Chinese enterprises are incorporated under Chinese

company law, this is in reality the China corporate bankruptcy law. Using the word “enterprise” was arguably to include some old business entities established as factories by the government during the planned economy era.

Just like the previous two pieces of legislation on enterprise bankruptcy, the new China Enterprise Bankruptcy Law of 2006 continues to apply to the bankruptcy of enterprises with an independent legal status. This means that sole traders (without an independent legal status) and individuals cannot access the formal bankruptcy law to address any debt problems they may experience.

Under the 2006 law, all companies incorporated in China are eligible to use the bankruptcy procedure in courts if they are deemed to be bankrupt either by a cash-flow or balance-sheet test.

When the China Enterprise Bankruptcy Law of 2006 was drafted, the draftsmen studied the bankruptcy laws from a number of jurisdictions, such as England and Wales, France, Germany and the United States. However, the greatest influence on the law clearly emanated from the USA and Germany. Chapter 11 of the US Bankruptcy Code 1978 largely reshaped the direction of the making of the China Enterprise Bankruptcy Law of 2006, when this powerful corporate rescue procedure was presented by Professor Wang Weiguo to his fellow law draftsmen in the 1990s. The rescue-oriented China Enterprise Bankruptcy Law of 2006 comprises three substantial bankruptcy options / procedures.

### **4.1.3 The options available under the new law**

#### *4.1.3.1 Reorganisation*

The first corporate bankruptcy option is reorganisation, with most of its elements borrowed from the US Chapter 11 procedure. When a company is bankrupt, it can trigger a corporate reorganisation procedure under the 2006 law; similar to Chapter 11, a voluntary reorganisation filing can be made without showing any evidence of bankruptcy; Article 2 of the China Enterprise Bankruptcy Law of 2006 states that when the company is likely to become bankrupt in the near future, the company can voluntarily file for reorganisation in court, meaning that a voluntary reorganisation filing does not need to pass any bankruptcy tests.

Another aspect similar to Chapter 11 is that the notion of debtor-in-possession has also been transplanted into the Chinese corporate reorganisation procedure. The only deviation contained in the Chinese debtor-in-possession procedure is that the privilege given to the debtor’s management is not automatic. At the time when a reorganisation petition is accepted by the court, a court-appointed administrator, which is a qualified insolvency practitioner / firm, will take control of the company’s assets and business affairs. However, following the commencement of the reorganisation procedure, the debtor’s management may request the court for a debtor-in-possession type order. If sanctioned by the court, the debtor’s management regains control from the reorganisation administrator, with the latter switching to the role of a supervisor for the remainder of the procedure only. Technically, if there is no debtor-in-possession request, the administrator remains in control and will steer the reorganisation through to the end.

The reorganisation plan should be voted on by creditors in four different classes. These classes are: i) secured creditors, ii) employees, iii) tax / revenue authorities, and iv) ordinary unsecured creditors. The reorganisation plan is passed if it is voted in favour of by 50% or more of attending creditors in number, representing two-thirds or more of attending creditors in value of each class. Another similarity to Chapter 11

of the US Bankruptcy Code is that a cram-down is also available under the China Enterprise Bankruptcy Law of 2006, since its Article 87 stipulates that the court may forcibly approve the reorganisation plan which failed to win the vote of all four creditor classes but meets certain statutory conditions.

#### *4.1.3.2 Composition / settlement*

Apart from the reorganisation procedure under the China Enterprise Bankruptcy Law of 2006, the second substantial bankruptcy option is also a rescue procedure called composition or settlement. Unlike the reorganisation procedure, which can be filed by both the company and its creditor(s), the composition procedure is reserved for a voluntary filing only.

Under Article 95 of the China Enterprise Bankruptcy Law of 2006, when the company files for composition it must also present a composition / settlement plan to the court. If the court is satisfied with the composition plan, a meeting of the creditors will be convened to vote on the plan. As already noted, most Chinese statutes are too vague and lack the necessary detail. The composition procedure under Chapter 9 of the China Enterprise Bankruptcy Law of 2006 says nothing about whether creditors should be lumped together to vote on the composition plan, or whether separate classes of them should be formed. Article 97 only states that the composition plan is passed if voted in favour of by half or more of attending creditors in number holding two-thirds or more of the total claims.

Similar to a corporate reorganisation plan that needs the final approval of the court, a composition plan voted in favour of by the creditors should also be sent to the court for approval before taking effect. However, Article 96 of the 2006 law states unequivocally that secured creditors are not bound by a composition procedure, which means that secured creditors are not subject to the stay that suspends all legal enforcement against the company's assets. Arguably, without the support of secured creditors, which are usually banks holding substantial claims, a composition effort is very unlikely to succeed.

The 2006 law uses two chapters, Chapters 8 and 9, to highlight corporate rescue; the intent of the Chinese lawmakers to promote the use of corporate rescue is therefore apparent.

#### *4.1.3.3 Liquidation*

The third and final bankruptcy option is liquidation, which can be found in Chapter 10 of the 2006 law. The order of these three substantial chapters arguably reflects that the lawmakers expect rescue to be attempted first.

As for the liquidation procedure, under Article 7 of the China Enterprise Bankruptcy Law of 2006, if the company is unable to pay a debt that is due, the creditor can file for liquidation in court. From this it is clear that for creditors a cash-flow bankruptcy test is used before the court will accept a liquidation petition. From the point of view of the company itself, Article 2 of this law allows the debtor to use either the balance-sheet or cash-flow test to convince the court that the commencement of a liquidation procedure is justified. In practice, submitting an audited balance sheet would be enough for the company to prove that it is balance-sheet or factually bankrupt (insolvent).

Under Article 10 of the China Enterprise Bankruptcy Law of 2006, in the event of an involuntary liquidation filing (for example, by a creditor) the company is given seven

days to raise an objection; but whether the liquidation procedure should be formally opened will be in the discretion of the court. While the statutory provisions look perfectly fine, in reality opening a bankruptcy procedure in a Chinese court is a very difficult thing to do. In most cases the courts simply ignore liquidation / reorganisation / composition petitions without providing any explanation. Consequently it can be argued that judicial accountability in China is very low.

If one is in the fortunate position to have a liquidation petition accepted by the court, which is usually co-ordinated or supported by local government, the liquidation procedure formally begins at this point. The court will appoint a qualified insolvency practitioner firm as the liquidator taking control of the company's assets and business affairs. The power of selecting liquidators is firmly in the hands of courts, rather than in the hands of creditors. Given that corporate bankruptcy is a lucrative business in China, the concern over the possible non-independence of judges in appointing liquidators has led to many provinces elevating this power to the regional intermediate or provincial supreme courts (see below for the court structure).

The commencement of the liquidation procedure will automatically trigger a moratorium / stay, according to which all enforcement action against the company's assets will be suspended under Article 19 of the China Enterprise Bankruptcy Law of 2006. After realising the company's assets, the proceeds will be used to pay the liquidation costs first, followed by payment of the employees' claims. Tax claims are paid after payment of the employees' claims, but before ordinary unsecured creditors. The *pari passu* principle applies if the proceeds cannot fully meet payment of the creditors of the same class.

In sum, the China Enterprise Bankruptcy Law of 2006 appears on the face of it to be a modern, advanced, rescue-oriented bankruptcy statute. However, the greatest challenge is the difficulty of implementing this law in the real world, since every year there are only a small number of court-involved bankruptcy cases. The vast majority of bankrupt companies in China simply continue to exist in the market in an unlawful manner, which jeopardises the interests of creditors.

## **4.2 Institutional framework**

### **4.2.1 General**

China has a four-layer court system. At national level it is the China Supreme People's Court, which is based in the capital city of Beijing. The second level is the provincial supreme people's courts (also translated as provincial high people's courts by some), which are established in the capital city of each province. The four big cities of Beijing, Shanghai, Tianjin and Chongqing are politically treated as provinces, resulting in these four cities also having their own supreme people's courts. The provincial supreme people's court instructs court services in the local province, hearing appeals and occasionally dealing with first-instance litigation.

Below provincial supreme people's courts are intermediate people's courts at the prefecture level, since each province is usually divided into several political units as prefectures in China. In most cases, the prefecture intermediate people's court is based in a large city. For example, in Shenzhen, a prefecture of the Guangdong province, there is the Shenzhen Intermediate People's Court.

At the bottom of the China court hierarchy are county people's courts, which correspond to the establishment of the county government in each smaller region in China. Needless to say, county courts only accept first-instance litigation. Where a

dispute involves a large claim, in most cases it must be dealt with by a local intermediate people's court instead. County courts are only allowed to deal with simple and less complex cases.

As for appeals, Chinese law only allows litigation parties to appeal once. The first appeal is final and a second or further appeal is not allowed. For example, if the first-instance case is heard before an intermediate people's court, the parties can appeal to the local provincial supreme people's court if they are unsatisfied with the first judgment and the appeal judgment is final. No second appeal to the China Supreme People's Court is permitted. Although many argue that China should adopt a one first-instance trial plus two-appeals system, it seems very unlikely that the current system will change.

Unlike in the USA, China does not have a separate bankruptcy court system. Bankruptcy cases are traditionally handled by the second civil chamber of each court. Generally speaking there are several chambers in each court, for example the criminal, first civil, second civil, and execution chambers. The criminal chamber, as its name suggests, deals with criminal trials. The first civil chamber handles disputes between individuals, most of them family issues and small claims. The second civil chamber was originally called the commercial chamber and was later renamed, focusing on commercial litigation, including corporate bankruptcies. In some big cities, some intermediate people's courts started to establish *ad hoc* bankruptcy chambers in recent years.

#### 4.2.2 Jurisdiction

As regards jurisdiction for a company bankruptcy procedure, according to a judicial notice released by the China Supreme People's Court in 2002, it firstly depends on where the company is located and where it operates from. The bankruptcy procedure must be opened in the court where the company's domicile, or "centre of main interests", can be identified. For example, for a creditor to file for the bankruptcy of a company operating in the city of Shenzhen, the creditor must go to that city to find an eligible court to lodge the petition. In most cases, the company's domicile is the company's official address registered at the China Industries and Commerce Regulation Bureau and its regional offices. In theory, if there is a difference between the company's registered address and the location of the company's major operation, it is the court where the company's main operation is located that will hear the bankruptcy case. However, in practice it is a challenge for creditors to present official evidence proving where the site of the company's operation is, so the safest way is to go to the court where the company's registered address is located in the first place.

Following the identification of territorial jurisdiction, the second step is to identify at which level of the court a bankruptcy petition can be filed. This depends on what level of the China Industries and Commerce Regulation Bureau local office in which the company is registered. If the company is registered at a county office of the China Industries and Commerce Regulation Bureau, its bankruptcy case should be heard by the local county people's court. Where the company is registered at the prefecture, or provincial or national office of the China Industries and Commerce Regulation Bureau, the bankruptcy petition should be filed at the local intermediate people's court. Companies registered at a county office of the China Companies House are usually small firms, so it is technically justifiable for a county court to handle the bankruptcy of these companies. Being registered at the prefecture (or higher) office of the China Industries and Commerce Regulation Bureau usually suggests that the company is a relatively large one, in which case its bankruptcy

deserves to be overseen by the local intermediate people's court, which is often better staffed. It is rare for provincial supreme people's courts to deal with corporate bankruptcies directly. The China Supreme People's Court itself, it seems, has never heard a corporate bankruptcy case.

#### **4.2.3 Efficacy of the court system**

As mentioned above, opening a corporate bankruptcy procedure in court is very difficult in practice. Although the total number of court-involved corporate bankruptcies in China increased to around 10,000 in 2017, it is estimated that there are still over 90% of bankrupt companies that should go through the bankruptcy procedure in order to exit the market, but have not. In most courts there have been no corporate bankruptcy cases for a decade. This is a judicial weakness in China, partly due to the fact that the court system does not get enough support from the government when dealing with corporate bankruptcies.

Given the difficulty of using the bankruptcy law, for creditors the only option is to rely on the individual debt collection system by suing the debtor and enforcing the monetary judgement at a later stage. Generally speaking, the Chinese court system is relatively efficient in dealing with commercial litigation and any subsequent judgment execution.

With regard to the individual debt collection system, in most cases Chinese judges would look at the legal provisions embedded in the statutes and in the judicial notices issued by the China Supreme People's Court when adjudicating commercial disputes. It is safe to say that most commercial litigation results are fair. For some large claim disputes, law courts generally welcome this type of litigation since this can generate a considerable amount of court fees. This is especially true in some underdeveloped regions in China, where law courts might not be well funded.

After obtaining a judgment, if the debtor still refuses to pay, the creditor can file for the execution of the judgment, usually in the same court. The execution chamber of the court will deal with the enforcement of the judgment. In many developed areas, such as Shanghai and Zhejiang, the execution staff can access company bank account records, real estate registration databases and company registration systems in their own offices, since their desktop computers are linked to the government authorities' internal systems online. This makes it relatively easy for execution officers to identify whether the debtor company has assets worth seizing / levying.

If the debtor company has cash in its bank account, the execution officer will issue an execution assistance notice to the bank, which is obliged to transfer the amount demanded to the court. Where the debtor is still financially healthy, seizing cash from its bank account is usually the most effective way of enforcing the judgment. Execution officers also favour this option, so they routinely visit banks to search for the debtor's assets in the form of cash deposits.

The second most popular way of judgment enforcement is to seize the debtor's buildings / houses, including the right to use the land that the buildings occupy. This also looks relatively easy, since most buildings and houses are officially registered at the China Property Registration Authority and a simple computer search can identify these assets. The main problem here arises when selling the houses or buildings. This difficulty becomes more acute for commercial or business buildings. In the case of business premises, if the debtor company is still in operation (especially in the case of a manufacturing company) the execution office usually has no confidence in

closing down the company by selling the company's buildings and evicting the company. Local government will never support this kind of destructive and powerful method of enforcement. Selling the company's building is usually the last resort, and is often carried out after the company has ceased trading.

The second difficulty is finding a buyer for the buildings, which can be challenging. This difficulty is exacerbated if the building does not have proper legal registration documents, something that occurs quite regularly. For many businesses in China, violating the planning laws when constructing commercial buildings is not uncommon. Consequently, the China Property Registration Authority local offices often tend to refuse to issue property ownership certificates, without which potential buyers are unwilling to purchase the property. It is not uncommon to see some creditors holding a large claim choosing to buy the property instead, since the market price cannot be fully realised through an auction.

Apart from seeking recourse against the debtor's real property, the execution officer may also seize movable assets, such as assembly lines, machines and even raw materials stored in the company's warehouse. This method works well in practice but in reality it is not preferred by either execution officers or creditors, since selling these types of assets is time-consuming and does not always yield satisfactory results.

In theory, if the debtor has receivables (book debts), the execution officer can send an execution assistance notice to the debtor company's debtors, forcing the latter to pay to the court instead. However, in this scenario the problem is that for outsiders, including execution creditors and execution officers, it is difficult to find and prove the existence of a particular receivable, let alone to force the third party to pay.

A tricky situation in practice is where a company is insolvent, it is unable to open an insolvency procedure but the company's assets have been frozen under concurrent judgment execution procedures in which there are two or more competing execution creditors. Before 2015, the second execution creditor taking action behind the first one could apply for fair distribution, that is, on a *pari passu* basis, to distribute the seized assets between the execution creditors. However, in 2015 the China Supreme People's Court abolished the *pari passu* principle in judgment execution against company (legal person) debtors. By contrast, if the execution debtor is a natural person or a business without an independent legal status, the application of the *pari passu* principle can still be requested by a late execution creditor in order to ensure fairness (albeit in a very limited sense, since *pari passu* can only be applied between execution creditors - non-litigating creditors have no right to join, let alone to share).

Being unable to use the company bankruptcy law to bring about a *concursum*, creditors in China may only realistically use individual debt collection mechanisms through litigation and the first in time, first in right rule, applies.

### 4.3 Insolvency practitioners

After the enactment of the first rescue-oriented China Enterprise Bankruptcy Law of 2006, China began to build its insolvency profession.

In 2017 and in order to facilitate the implementation of the China Enterprise Bankruptcy Law of 2006, the China Supreme People's Court instructed most provinces to gradually establish their own regional qualified insolvency practitioner lists. The word "qualified" is perhaps a bit misleading since most, if not all, provincial supreme courts simply select some local large law and accounting firms to be included in the lists without going through any qualification exams or training

courses. It seems a bit self-deceiving for many of the provincial supreme people's courts to claim that they have a list of qualified insolvency practitioners. Be that as it may, if a law firm is included in the local list it can receive appointments as liquidator in the bankruptcy of a company, which is currently a profitable business in China.

The power of including a law or accounting firm in the official insolvency practitioner list is generally exercised by provincial supreme people's courts, which always seek collaboration from local lawyer and accounting associations. These two associations are actually controlled by local government justice and finance departments, respectively. For lawyers and accountants, the competition to be listed is fierce but whether or not they are included mostly depends on the size of the law or accounting firm concerned. In these cases size matters, since most provincial courts assume that a large law or accounting firm is more trustworthy both in terms of financial strength and in respect of competence.

Given that annually there are only a small number of company bankruptcy cases, only a handful of privileged law and accounting firms are given the chance to take appointments. For example, the first Shanghai insolvency practitioner list was made by the Shanghai Municipal Supreme People's Court in 2007, with 12 law firms, four accounting firms and four liquidating firms listed. In 2015, the Shanghai Municipal Supreme People's Court updated the first list by publishing a second list comprising 19 law firms, nine accounting firms and three liquidating firms. Generally speaking, law firms dominate insolvency practitioner lists across China.

As regards the supervision of "qualified" insolvency practitioners, it seems that there is a vacuum. Provincial supreme people's courts are not executive branches of local government, so it seems counterintuitive for them to regulate and monitor the work of insolvency practitioners. Attempts at forcing provincial supreme people's courts to monitor insolvency practitioners has been met with resistance in practice. Disgruntled parties seeking to hold insolvency practitioners accountable for any alleged breaches of a bankruptcy administrator's duties, can therefore probably only lodge complaints with the professional organisations to which these insolvency practitioners belong, for example the local lawyer and accounting associations.

However, considering that it is not only law and accounting firms that can be appointed but also so-called "liquidating firms", this situation is far from ideal. There is currently no association or body where complaints can be made should the liquidator firm not be a law or accounting firm.

Currently there are no government agencies regulating insolvency practitioners in China. Professor Li Shuguang has long been campaigning for the establishment of an executive branch of the government for supervising insolvency practitioners and dealing with some non-asset company bankruptcies, but it seems that his suggestion is very unlikely to be adopted by the Chinese government in the near future. Some lawmakers also echoed the call of Professor Li Shuguang, but given the inflated size of the Chinese state machine as a whole, arguably this initiative may never be considered by the state in China.



**Self-Assessment Exercise 1****Question 1**

Briefly explain China's two debt collection systems.

**Question 2**

Can an execution officer in China seize and sell the commercial buildings of the execution debtor to meet a judgment payment? If so, what are the difficulties when the execution officer attempts this method of enforcement?

**Question 3**

Does the China Enterprise Bankruptcy Law of 2006 apply to the bankruptcy of sole traders who have no independent legal status?

**Question 4**

Does the China Supreme People's Court directly hear corporate bankruptcy cases? Explain the company bankruptcy work allocation between the courts at the different levels in China.

**For commentary and feedback on self-assessment exercise 1, please see  
APPENDIX A**

**5. SECURITY**

Under the China Property Law of 2007, there are generally three forms of security available, namely fixed charges, pledges and liens.

**5.1 Fixed charge**

The first and most widely used form of security is the fixed charge. Floating charges are also recognised in China, but are infrequently used due to a lack of supporting mechanisms. In most cases a charge can be created over both movable and immovable property in favour of a secured creditor (usually a bank). A charge can be created over the debtor's assets or even over the assets of a third party, provided the third party's consent has been obtained in advance.

A charge must be registered under the China Property Law of 2007 and is not valid until it has been registered. A security certificate is issued to the charge holder once the charge has been properly recorded at the government agency. A small fee may apply for the registration of a charge. For immovable property the registration authority is the local office of the China Housing Management Authority and, for safety, most secured creditors tend to simultaneously register the charge at the local office of the China Land Management Authority, since the use right of the land upon which the building stands is part of the property.

In theory, under Article 45 of the China Guarantee Law of 1995 all registered charges on buildings and use rights over land should be open to the general public for inspection. However, Article 45 does not state what sanction should be imposed should the registration authority fail to comply. Despite the provisions of Article 45 in this regard, in practice it is very difficult to access the records at the China Land Management Authority, even for most lawyers. Guanxi works better.

Fixed charges are mostly used in relation to immovable property (buildings, houses and the associated land use rights). In China, all land is generally owned by the State and no private party is allowed to take ownership of land. The right to use land, essentially a lease, can be purchased by private parties, including individuals. If there are no buildings on the land yet, the pure right of use relating to a piece of land can also bear a charge, subject to registration.

Arguably, most companies having immovable property borrow money from banks by creating fixed charges. Even in the event that a company has unencumbered property, local banks will chase the company to offer cheap loans on the condition of obtaining a fixed charge.

Most fixed charges in China are created upon buildings and the right of use of land. Occasionally a fixed charge will also be registered over movable property, such as vehicles and machinery, but this is not a regular occurrence. For vehicles, the registration authority is the local police vehicle management office; for machinery and other equipment, the local office of the China Industries and Commerce Regulation Bureau is responsible for registering charges.

Generally speaking, charges are well respected by Chinese courts, especially in bankruptcy procedures where charge holders will be paid first once charged assets have been realised. There are a couple of reasons for the proper treatment of fixed charges by China's courts. Firstly, it should not be forgotten that most fixed charge holders are powerful state-owned banks in China and have their own political means to pressure courts into doing the right thing. Secondly, there is an increasing number of judges being university educated, creating an awareness of the issues at play and contributing to an understanding of the law.

At the moment, the only threat to fixed charges in China would be employee claims. In the event of the bankruptcy of a debtor company, if the company's only valuable assets are encumbered, regardless of whether a bankruptcy procedure is entered into or not, banks as secured creditors are usually required to surrender part of their security to allow employees to be paid first. Law courts have their own difficulties in this regard, as unpaid employees may petition local government in groups, causing social instability. To alleviate social instability concerns, courts under the political pressure of local government will quite regularly coerce banks into making a concession, even though it is unlawful to do so. It is worth noting that the principle of respecting fixed charges may be adversely affected in this situation, but in real terms only a small portion of charged assets will ever go to employees. This is mainly due to the fact that employee claims are usually quite small (in many cases less than RMB 100,000), especially compared to bank loans which tend to be large sums running into several millions of RMB.

To realise fixed charges (in principle with the consent of the chargor under the China Property Law of 2007, Article 195) the chargee can directly sell the charged assets to meet the secured debt without having to approach the court. However, in reality this provision is largely a dead letter on the statute book, as secured creditors must initiate a litigation procedure and ask the court to sell the charged property in the

subsequent execution procedure. If a bankruptcy procedure is opened, the chargee can simply rely on the court-controlled liquidator to honour the security.

## 5.2 Pledge

Apart from fixed charges under Chapter 17 of the China Property Law of 2007, pledges are also used, although less frequently. A pledge, as a matter of principle, becomes valid after the pledged movable asset changes possession into the hands of the secured creditor. For movable assets, no registration of a pledge is required as the change of physical possession itself (delivery) is sufficient. Apart from movable tangible assets, many intangible assets, such as trademarks, patents, shares, cheques and even bonds, can also be pledged. However, for these pledges to be valid they must be registered, otherwise they are invalid.

In regard to pledge registration authorities, these vary considerably and can be quite complex. For trademarks, the registration authority is the China Industries and Commerce Regulation Bureau Central Office located in Beijing. A pledge on patents should be registered at the China Intellectual Property Authority Central Office, also located in Beijing. For shares of listed companies, the registration authority is the China Securities Depository and Clearing Corporation Limited, a state-owned company that has offices in Beijing, Shanghai, Shenzhen and Hong Kong. In the case of shares of a non-listed company, the registration of a pledge takes place at the local office of the China Companies House where the company is incorporated.

Given that pledges are not often used in practice, understanding the general principles of pledges in China is sufficient.

## 5.3 Liens

The final form of security is the lien, which is regulated by the China Property Law of 2007. Liens are not often used as a form of security in the commercial world in China.

### Self-Assessment Exercise 2

#### Question 1

Explain the three forms of securities recognised under the China Property Law of 2007.

#### Question 2

Explain how to realise fixed charges in China's courts.

#### Question 3

Between charges, pledges and liens, which form of security is used the most in the commercial world in China?

**For commentary and feedback on self-assessment exercise 2, please see APPENDIX A**

## 6. INSOLVENCY SYSTEM

China presently only has bankruptcy legislation for enterprises / companies, without having formal bankruptcy law for individuals. Under the Communist regime, China struggled to implement its first enterprise bankruptcy law back in 1986, but this law was rarely used, largely due to the fact that the Chinese government did not actually expect to use this law for either the fair protection of creditors or for an orderly liquidation of failed SOEs. Instead, it aimed to use a formal bankruptcy law to coerce underperforming SOEs into operating more efficiently. As already explained, in 2006 China updated its bankruptcy law, leading to the promulgation of the China Enterprise Bankruptcy Law of 2006, a rescue-oriented piece of modern bankruptcy legislation. The 2006 bankruptcy law applies to the bankruptcy of both SOEs and private companies.

### 6.1 General

On the face of it, the China Enterprise Bankruptcy Law of 2006 appears to be creditor-friendly. However, in reality it seems fair to say that the law is court-friendly, for it gives almost unlimited powers to courts, with both creditors and debtors being marginalised in the process.

When a formal bankruptcy procedure is entered into, it is the court that has the exclusive power to appoint a bankruptcy administrator, in most cases an insolvency practitioner firm. When the 2006 law was drafted, many scholars suggested that the administrator should be appointed by creditors instead. But the China People's Congress believed that giving this power to the court would contribute the neutrality of the appointed administrator and as a result creditors have little say regarding who get appointed as administrator. Although Article 22 of the China Enterprise Bankruptcy Law of 2006 authorises creditors to request the replacement of the court-appointed administrator by way of a resolution at the creditors' meeting where the incumbent administrator behaves unlawfully or is biased, this generally does not happen in practice. This is because the court has control over the creditors' meeting and the motions for the replacement of the administrator are rarely heeded.

As for control over the company's assets and business affairs, it is generally in the hands of the court-appointed administrator who will realise the assets and distribute the proceeds to creditors. Under Article 61 of the China Enterprise Bankruptcy Law of 2006, the final value distribution plan prepared by the bankruptcy administrator must pass a vote at the creditors' meeting. However, Article 65 provides the court with special powers, stating that if the plan, the most significant document in any bankruptcy case, was voted down at the creditors' meeting, the court has the final say as to whether it will be implemented. Many commentators argue the fact that holding a creditors' meeting is largely only a formality, undermining creditor protection in the process.

As already mentioned, bankruptcy administrators are selected from a local list of insolvency practitioners. While under the law it seems that the administrator is in full control of the bankruptcy process, the reality is that the administrator acts under the authority of the judge overseeing the case. In many cases it is the judge in charge who makes key decisions regarding the bankruptcy process. Even simple administrative functions, such as convening the first creditors' meeting under Article 62 of the China Enterprise Bankruptcy Law of 2006, are performed by the court, not the administrator.

## 6.2 Personal / consumer bankruptcy

Like many former Soviet-influenced nations, at least until recently, China still does not have a consumer bankruptcy law, mainly due to the Communist ideology that still applies in China and the belief that personal bankruptcy is an exclusive social failure reserved for capitalist societies. However, having no personal bankruptcy law in China does not mean that there is no personal bankruptcy. Personal bankruptcy takes place as frequently as in other advanced jurisdictions and this section sheds some light on how personal bankruptcy in China is handled outside the formal bankruptcy system.

Generally speaking, creditors facing an individual who is unable – or unwilling – to pay a debt that is due, the only option is to resort to the individual debt collection regime under the China Civil Procedure Law of 1991 (updated several times in recent years), by suing the debtor and initiating an execution procedure afterwards. For judgment creditors, if the judgment debtor does not have sufficient assets to meet judgment payment, Article 254 of the China Civil Procedure Law of 1991 provides that the judgment debtor must keep honouring the debt payment and that if the judgment creditor can in future identify any assets belonging to the debtor, the execution procedure may be resumed at any time. The Civil Procedure Law obviously does not state that in this situation a bankruptcy procedure should be opened, since there is no bankruptcy procedure for individuals in China.

Where there are multiple judgment creditors, that is, there is more than one creditor opening a judgment execution procedure against a consumer debtor and the debtor does not have sufficient assets to meet the judgment payments, the China Civil Procedure Law of 1991 is silent as to what should happen. It is submitted that the China Legislature should at least have expressed some general principles in upholding fairness in this situation. For the law courts encountering this situation regularly in practice, they have to find a practical solution to the problem. This solution can be found in the judicial notices issued by the China Supreme People's Court.

Under a judicial notice on civil procedures released by the China Supreme People's Court (and last updated in 2015), in the event of the bankruptcy of an execution debtor who is an individual and who does not have sufficient assets to meet the judgment payment of more than one judgment creditor, the judgment creditors may apply to the execution officer who has seized the debtor's assets for a *pari passu* distribution. Essentially this amounts to applying the bankruptcy principle of *pari passu* amongst all execution creditors, which is akin to a bankruptcy procedure. However, care must be taken in understanding the limits of the application of the *pari passu* principles in a number of respects.

Firstly, from the point of view of creditors, only a very limited group of creditors are eligible for the potential *pari passu* distribution in judgment execution, since the aforementioned judicial notice only allows the creditor who has obtained a final judgment in his favour to request *pari passu* distribution. This means that a creditor who has not taken legal action in court, or who has taken action but has not received a favourable judgment prior to the distribution, will not be entitled to join the fair distribution of the proceeds. It should be clear that if there was a formal bankruptcy procedure, all creditors would be entitled to share in the proceeds on a *pari passu* basis.

Secondly, only a very narrow window of opportunity for sharing in the *pari passu* distribution exists, as the judicial notice states that any *pari passu* distribution

application must be filed with the execution officer who has seized the assets of the judgment debtor before the realised proceeds are handed by the execution officer to his own execution creditor. This has a particularly harsh impact on creditors who may be late in applying to share in the distribution. This situation brings about its own problems which will not be covered in this text.

Thirdly, only a limited range of the execution debtor's assets are potentially subject to the *pari passu* distribution in judgment execution. This is due to the fact that (unlike bankruptcy liquidators) execution officers have no power – and are unwilling – to thoroughly investigate the debtor's assets, let alone to exercise the available transaction avoidance powers so as to increase the asset pool in the interest of all creditors. In practical terms, the execution officer only looks at what assets are immediately available in the form of bank deposits or fixed property. As a result, any hidden assets of the debtor would not be recovered to pay execution creditors. For example, if the execution debtor transferred his bank deposits to his relatives or friends in order to frustrate the execution effort shortly before the execution procedure, the execution officer is almost powerless to do anything as no transaction avoidance powers can be exercised in this situation.

Finally, another key weakness of the *pari passu* distribution in judgment execution is the fact that there is no publicity of the action by which the execution debtor's assets have been seized. This means that creditors who have not yet instituted action would be unaware that the debtor's assets have been seized and would not be able to share in the distribution of the proceeds. Some judges suggest that in the event of the seizure of a substantial asset of the debtor, if the execution judge reasonably believes that there might be other competing creditors, the seizure should be advertised so that other creditors can take steps to share in the proceeds. Despite such suggestions, it would not appear that any judge has actually done this in practice. Late creditors are therefore compelled to use unofficial channels to access information in order to for a potential share in the distribution.

Over the past 10 years there have been repeated calls for China to enact a personal bankruptcy law, even from China's own Supreme People's Court. However, it seems unlikely that China will enact such a law in the foreseeable future. Bearing in mind that the current leadership in China is trying to consolidate the state sector, including the expansion of state ownership in a growing number of industries, the possibility of a personal bankruptcy law being promulgated in China remains slim.

### Self-Assessment Exercise 3

#### Question 1

Given that in China there is no personal bankruptcy law, how can creditors seek fairness under the current legal landscape?

#### Question 2

Explain the limitations on *pari passu* distribution in judgment executions in China.

**For commentary and feedback on self-assessment exercise 3, please see APPENDIX A**

## 6.3 Corporate liquidation

### 6.3.1 Eligibility

Under Article 2 of the China Enterprise Bankruptcy Law of 2006, to be eligible for a formal bankruptcy liquidation procedure the debtor must be an enterprise with an independent legal status. The vast majority of legal person enterprises in China are companies incorporated under the China Company Law of 1993. In practice, the great majority of enterprises in existing bankruptcy liquidation procedures are also companies.

Enterprises without independent legal status are generally small businesses registered as sole traders or partnerships. According to some statistics, 70% or so of registered businesses in China are sole traders and as such cannot enter into a formal bankruptcy procedure for liquidation.

### 6.3.2 Commencing the procedure

To enter into a liquidation procedure, a liquidation petition can be filed by either the debtor or a creditor. Tax authorities are creditors but it is very rare to see cases where the tax authority files for the bankruptcy of a company in China (although technically they are given the right to do so). Employees with unpaid wages are also creditors and occasionally they act as filing creditors in bankruptcy cases. In most cases it is trade or banking creditors who file for bankruptcy. Under Article 7 of the China Enterprise Bankruptcy Law of 2006, the filing creditor must convince the court that the debtor is cash-flow insolvent, namely that the debtor is unable to pay a debt that is due. Although this is what the law states, without the support of local government in practice, creditors simply relying on Article 7 to initiate a bankruptcy liquidation procedure in court is impractical as there is a very good chance the bankruptcy application will simply be ignored, if not rebuffed.

For a voluntary liquidation filing, evidence of cash-flow or balance-sheet bankruptcy must be presented to the court by the debtor before a formal liquidation procedure will be considered. Usually the debtor is in a position to provide an audited financial report to prove that the company is balance-sheet insolvent. Again, this is only what the law states and does not reflect reality. The reality is that the court will treat the debtor in the same way a filing creditor is treated. While government support for bankruptcy applications is not written and not legally required in the law, it is usually a very real condition for the commencement of a court-involved liquidation procedure.

There is a paragraph under Article 7 of the China Enterprise Bankruptcy Law of 2006 that states that in the event of the company's voluntary dissolution under the Chinese Company Law, if the dissolution team / committee finds that the company's assets cannot fully meet the payment of its liabilities (that is, the company is bankrupt), the dissolution team is obliged to file for bankruptcy liquidation at the court. This provision is a little misleading since the vast majority, if not all, of failed companies in China do not go through any formal dissolution procedure and shareholders and management simply walk away without taking any responsible dissolution action. As a result, entering a liquidation procedure via this route is rarely seen in the real world in China.

Holding companies and directors to account under the formal bankruptcy law is a challenge. This is largely because China does not have any provisions whereby the directors can be held accountable in the same way, for example, that a wrongful

trading regime would in a different jurisdiction. Company directors are not obliged to file for bankruptcy once they become aware of the bankruptcy of the company and, even if they did, their petition would be very unlikely to be entertained by courts. Article 125 of the China Enterprise Bankruptcy Law of 2006 states that if the company's bankruptcy is due to the company directors' violation of their duty of good faith and diligence, they must be held to account. While this Article only states a general principle, whether it can be interpreted as a fiduciary duty of directors and can be used to force directors to file for bankruptcy in a timely manner, remains untested. In practice this Article is largely a dead letter as it is too generally stated to be of any use.

To promote more corporate rescues, Article 70 of the China Enterprise Bankruptcy Law of 2006 stipulates that in the event of an involuntary liquidation procedure, the debtor or its shareholders holding 10% or more of the company's equity can apply to court for a conversion from liquidation to reorganisation. However, this gives rise to several problems.

First, given that following the commencement of a liquidation procedure the company is fully controlled by the court-appointed administrator and the company's own management is routinely dissolved (having been replaced by the administrator), it is not clear how the debtor's board can exercise its right to raise a legitimate conversion request.

Second, empowering shareholders to raise a conversion motion also seems to be untenable, as entering into liquidation means the company must have been able to meet the bankruptcy test. Allowing shareholders to substantially alter the course of bankruptcy in this way seems to be unjustifiable. It is submitted that doing so would be at the expense of creditors.

Third, the conversion request must be submitted to the court that then also makes a decision in this regard, which is controversial. In these circumstances, it is the creditors whose interests are at risk and ideally it should be the creditors (rather than the court) who should legitimately decide whether or not to convert the current liquidation into a reorganisation procedure. Although Article 70 allows for a conversion from liquidation to reorganisation, this only takes place in a very small number of cases in practice.

### **6.3.3 Consequences of commencement**

At the point when the liquidation petition is accepted by the court, a general moratorium applies. Under Article 19 of the China Enterprise Bankruptcy Law of 2006, secured creditors are also bound by the moratorium. It is noteworthy that the bankruptcy liquidation procedure in China officially begins at the time when the liquidation petition is accepted by the court and not at the time when the petition is filed. There is a time gap between when the petition is submitted and when the petition is accepted by the court. The moratorium suspends all execution against the company's assets only after the court has decided to accept the liquidation petition.

The Article 19 moratorium appears to have at least two defects. Firstly, it seems that the law makers did not anticipate that legal action might be taken by government agencies (such as tax authorities, police and customs officials). Whether legal actions imposed by government agencies rather than the courts should also be subject to the moratorium remains uncertain. In principle it seems that government action on the company's assets in liquidation should also be suspended by the moratorium, although there is a real concern that Article 19 does not clearly provide



specific answers for this. In real cases it sometimes happens that government authorities (especially the customs authority) seize the company's assets and disregard the moratorium issued by the court. This troubles bankruptcy judges and administrators considerably in practice.

Secondly, law courts in China are like government agencies and many (if not most) courts refuse to withdraw the asset freezing orders over the company's assets when the bankruptcy case is being handled in a different court, resulting in the moratorium not being respected by the Chinese courts themselves. In constitutional terms, this is mainly due to the fact that Article 19 only states that the moratorium applies when the formal bankruptcy liquidation commences (that is, when the order is granted). Without the asset freezing orders imposed by other courts being lifted, the bankruptcy administrator cannot dispose of these assets, which may derail the whole liquidation procedure.

Generally speaking, when a company is on the verge of bankruptcy, there is no formal compromise procedure that can be used under the China Company Law. A UK-type Scheme of Arrangement has no counterpart in China. However, this does not prevent the company from negotiating a settlement with its creditors and shareholders under contract law, if a settlement can be unanimously agreed. Unanimity is obviously very difficult to achieve in practice.

#### **6.3.4 Appointment of liquidator**

As noted above, when the liquidation petition is accepted by the court, Article 13 of the China Enterprise Bankruptcy Law of 2006 provides for the simultaneous appointment of the bankruptcy administrator (the term used to name a liquidator or trustee in China) by the court. The Chinese courts generally use the roster of the locally qualified bankruptcy practitioner list to select the candidate firm and occasionally a bid will be held if the case proves to be complex and large. Presumably in an effort to reduce any opportunities for corruption, in many provinces the power of appointing bankruptcy administrators has been elevated to the local provincial Supreme People's Court (for example, in Beijing). In other provinces (for example Zhejiang), this power can only be exercised by a local Intermediate People's Court.

At the time the China Enterprise Bankruptcy Law of 2006 was drafted, many scholars suggested that a provisional liquidator should be appointed by the court to take over the company's assets and business affairs until the creditors' meeting takes place, the idea being that creditors should appoint a liquidator at the creditors' meeting. However, the China People's Congress did not adopt this suggestion, allocating this power exclusively to the courts. In an apparent attempt to strike a balance, Article 22 of the China Enterprise Bankruptcy Law of 2006 allows creditors to request a replacement of the bankruptcy administrator if there is evidence of the court-appointed administrator's lack of competence and impartiality. Creditors cannot question the court-appointed administrator's appointment without presenting evidence of lack of competence and impartiality, which makes the challenge unlikely to succeed. It is rare to see successful challenges in practice.

#### **6.3.5 Powers and obligations of the liquidation administrator**

After being appointed, the liquidation administrator will assume control of the company's assets and business affairs, using a wide range of powers bestowed by the China bankruptcy law. Essentially, the liquidation administrator will perform the following tasks.

The liquidation administrator advertises the bankruptcy procedure in both local and national newspapers in order to inform all creditors that they should submit claims. Verifying claims from creditors is critical in ascertaining the company's total liabilities. In the event that the administrator cannot agree on the amount of the claim with an individual creditor, litigation will ensue in the same court to adjudicate the dispute. The final result of the litigation serves as the finalised amount of the disputed claim. In practice, this represents a significant part of the administrator's work.

The bankruptcy administrator must examine the company's books in order to trace the company's debtors and the amount of receivables, in addition to the existing assets already listed in the company's balance sheet. Under Article 46 of the China Enterprise Bankruptcy Law of 2006, the company's debt that is not yet due at the point of entering into the liquidation procedure is deemed to be due, so that the bankruptcy administrator can instruct the debtor to pay immediately. If the debtor fails to pay, litigation will be petitioned by the bankruptcy administrator on behalf of the company and a potential execution procedure may follow if the administrator is successful with the case. This obligation also occupies a great part of the administrator's time in practice.

Disposing of the company's assets is one of the most difficult tasks performed by the bankruptcy administrator, especially in dealing with the company's use rights of land and buildings. This is so due to the fact that many companies in China often breach the Chinese land planning laws when constructing their buildings; as a result, it is not uncommon to see that many buildings do not have proper legal documents. All these problems will come to the fore when the buildings are presented for sale. The bankruptcy administrator, under the guidance of the court, will usually request local government senior officials to intervene in order to assist with the sale of assets. The availability of this support is not without an associated cost, since obtaining the required legal documents can cost up to a quarter of the property's value in some cases.

In principle, all the company's assets should be sold by auction. In recent years, the Chinese court system made considerable progress in auctioning bankruptcy assets by collaborating with the online asset sale platform Alibaba, which supports the court system in selling these assets in a transparent and efficient way. After selling the company's assets, most of the substantial work has been completed and the administrator can distribute the proceeds under the priority order embedded in Article 113 of the China Enterprise Bankruptcy Law of 2006.

In theory, the bankruptcy administrator is obliged to investigate the causes of the bankruptcy of the company and to make recommendations as to whether certain management personnel should be investigated / prosecuted for any pre-bankruptcy misconduct. However, in reality most bankruptcy administrators tend to ignore this legal obligation, partly due to the difficulties in bringing these to a successful conclusion.

### **6.3.6 Executory contracts**

In regard to pre-bankruptcy contracts that have not been fully performed, the bankruptcy administrator is entitled to decide whether the contracts should continue to be honoured. Under Article 18 of the China Enterprise Bankruptcy Law of 2006, the bankruptcy administrator should inform the other contracting party of its decision as to whether to terminate or continue with the contract. Should the other contracting party not receive notification from the bankruptcy administrator within a period of two months, the contract will be deemed to have been terminated. However, if the

bankruptcy administrator remains silent for a period of more than 30 days after having received a request from the debtor asking for clarification over the fate of the unfulfilled contract, the contract will also be deemed to be terminated. Any losses on the part of the third party will form part of the claim by that party (for damages) against the company. In order to protect contracting third parties where the administrator has indicated that the contract should be completed, Article 18 provides that the third party has the right to demand security from the bankruptcy administrator for the proper performance of the contract. Should this security not be provided, the contracting third party has the right to unilaterally terminate the contract.

As far as utility creditors are concerned, the China Enterprise Bankruptcy Law of 2006 does not contain any specific provisions and these creditors will simply be treated as ordinary creditors. The problem is that utility companies, such as water and power suppliers, tend to exploit their monopoly by demanding priority payment for pre-bankruptcy unsecured claims. In this situation, local government intervention is critical if the bankruptcy administrator wants the company's affairs to be run smoothly. Usually the bankruptcy administrator will seek support from the courts in these circumstances.

### **6.3.7 Set-off**

Under Article 40 of the China Enterprise Bankruptcy Law of 2006, a creditor who is also a debtor of the company can claim set-off, with only the balance still owing being treated as a claim. However, certain restrictions apply. For example, the set-off debt cannot be purchased from a third party, that is, strict mutuality of claims must be applied and proved. In the case of bank creditors, it is not common for them to claim set-off where the company has deposits with the bank and also owes money to the bank. Theoretically, in this situation the bank could retain the company's deposits to partially set off an unpaid loan.

### **6.3.8 Voidable transactions**

Transactions at an undervalue taking place within one year prior to the commencement of a bankruptcy liquidation procedure can be avoided by the bankruptcy administrator by approaching the court for an order to this effect. Under Article 31 of the China Enterprise Bankruptcy Law of 2006, these transactions include those in which:

- (a) the company transferred assets to a third party as a gift, or for no consideration;
- (b) the company deliberately entered into a transaction at an undervalue at the expense of the company;
- (c) the company created a new security for an existing unsecured debt;
- (d) the company paid a debt that was not due; or
- (e) the company forgave a debt.

Unlike many insolvency systems that require the company to be insolvent at the time when the voidable transaction at an undervalue took place, Chinese law is broader in that, since it is irrelevant whether the company was bankrupt at the time or not. This provides China's bankruptcy administrators with more powers to increase the common pool of assets in the interests of the creditors as a whole.

For transactions that qualify as a preference, Article 32 of the China Enterprise Bankruptcy Law of 2006 states that the liquidation administrator can apply for a court order so as to avoid transactions that took place within six months before the beginning of the liquidation procedure. This is on condition that the company was aware of its bankruptcy at the time, but still paid some individual creditors in preference to other creditors. However, the transaction will not be deemed to be a preference if the payment was made for the benefit of the company.

### **6.3.9 Directors' liability**

As for holding unscrupulous directors or managers to account, the provisions in the China Enterprise Bankruptcy Law of 2006 seem to be too general to be used effectively. Article 6 of the China Enterprise Bankruptcy Law of 2006 provides that the court, in dealing with enterprise bankruptcies, should protect employees and hold enterprise management to account. This Article is rather controversial, as it does not match the powers of the court under the Chinese legal system.

Strictly speaking, director disqualification is also legally available under the China corporate bankruptcy law, since Article 125 of the China Enterprise Bankruptcy Law of 2006 asserts that the company's directors and senior management, who are proved to be responsible for the company's bankruptcy, could be disqualified for a period of three years during which they are forbidden from acting in the same roles in companies. However, this Article is too imprecise to be used effectively in practice and, as a result, director disqualification is virtually non-existent in China.

In most bankruptcy cases it can probably be said that the bankruptcy administrator does his best to maximise the return to creditors and does not have the time to hold rogue directors to account. It is also probably true to say that holding directors accountable will not result in any additional returns in the interest of creditors.

### **6.3.10 Priority claims**

As regards the distribution of what the bankruptcy administrator has realised from the disposal of the company's assets, the bankruptcy costs, including the administrator's fees and the post-bankruptcy expenses, must be paid first. Thereafter, employee claims are ranked before any claims by the tax authorities. In some cases, employee claims can be formidably high, since some big companies may have defaulted in paying wages for years. In addition to wages, employee pension contributions that have not been paid can also be very high and these types of preferential debt may take up the bulk of what the bankruptcy administrator has realised. As for tax authority claims, the question arises as to whether fines should also be included as preferential debts, ranked ahead of ordinary unsecured debts. Some courts have been bold, treating tax fines as ordinary unsecured debts. However, some courts, under pressure from the tax authority, tend to include the fines with the defaulted principal tax payment. Ordinary unsecured creditors are ranked as the last class of creditors to be paid. In most cases, the unsecured debt recovery rate is very low at around 5%.

### **6.3.11 Groups of companies**

The China Enterprise Bankruptcy Law of 2006 does not have any specific provisions that deal with groups of companies, although in practice there are two ways of dealing with company group insolvencies. The first is to strictly respect the legal personality of each company in the group, that is, the bankruptcy of a group of

companies is procedurally dealt with in the same court and even by the same bankruptcy administrator, but this is merely for administrative convenience with no substantial consolidation taking place. The second manner in which groups of companies are dealt with is more contentious, as it amounts to substantially consolidating the companies in the same group, ignoring the legal personality of the individual companies and treating the entire group as one legal entity. That this is so is partly due to practical necessity. In everyday commercial life in China it is not uncommon to see a controlling shareholder registering several companies, each of which serving as an economic unit or division within the controlling shareholders' business kingdom, with the legal personality boundaries between companies within the group considerably blurred. When bankruptcy occurs, it becomes virtually impossible to distinguish the assets and liabilities between each individual company.

With the support of the court, the companies within the same group are consolidated with the aim of treating the creditors of all the companies more fairly. In practice it is usually the administrator who asks for court approval to consolidate the bankruptcy of the group of companies. Generally, the law on group company insolvency remains underdeveloped in China and research is urgently required in order to address the problems that occur in practice.

### **6.3.12 Dissolution / deregistration**

After realising the company's assets and paying the creditors, Article 21 of the China Enterprise Bankruptcy Law of 2006 provides that the bankruptcy administrator must submit the court's liquidation completion order to the China Industries and Commerce Regulation Bureau local office in order to deregister the company. Presenting a hard copy of the court's liquidation completion order to the Companies House is theoretically sufficient to remove the company from the official list.

However, the practical reality is that the China Industries and Commerce Regulation Bureau often adds further burdens before deregistration, demanding for example that the deregistration request must be accompanied by a supporting reference from the local tax authority proving that the company does not have unpaid tax liabilities. As noted above, sometimes the tax fines are subordinated and are not paid in full, resulting in the administrator being unable to provide the tax clearance reference in order to have the company deregistered. It is therefore quite common to still see some companies on the official company list at the China Industries and Commerce Regulation Bureau, long after the bankruptcy has been concluded. Although this highlights a problem regarding collaboration between state agencies in China, it does not really have any practical repercussions since post-bankruptcy companies are usually labelled with a suspension status on the official company list and are generally unable to conduct businesses as normal.

### **6.3.13 SME insolvencies**

Currently there is no special bankruptcy procedure tailored for small companies, although in some advanced regions, for example in the Zhejiang province, local provincial supreme people's courts work hard to ensure a special expedited procedure to deal with the bankruptcy of SMEs. At national level there is still much that needs to be done in order to plug this gap.

**Self-Assessment Exercise 4****Question 1**

What types of business are eligible to use the China Enterprise Bankruptcy Law of 2006?

**Question 2**

How can a bankruptcy liquidation procedure be converted into a reorganisation procedure under the current Chinese bankruptcy law?

**Question 3**

Can director disqualification be applied in a practical manner under the China Enterprise Bankruptcy Law of 2006?

**Question 4**

Explain the two major approaches in dealing with the bankruptcy of company groups in China.

**For commentary and feedback on self-assessment exercise 4, please see  
APPENDIX A**

**6.4 Receivership**

There is generally no receivership under Chinese law. Please see the section on security where the options available to secured creditors have been discussed.

**6.5 Corporate rescue****6.5.1 General**

Generally speaking, there are no informal creditor workouts in China. Of course, this does not mean that a settlement arrangement cannot be reached between parties under contract law, but such an arrangement requires the unanimous support of all parties involved.

Regarding China's formal corporate reorganisation procedure, Article 2 of the China Enterprise Bankruptcy Law of 2006 stipulates that it is only open for use by enterprises having an independent legal status. This means that most companies are eligible to enter into a formal corporate reorganisation procedure. However, sole traders and partnerships are not able to make use of this procedure.

**6.5.2 Commencement**

To initiate a formal bankruptcy reorganisation procedure, the petition to the court can be made either by the company or its creditors. Article 2 of the China Enterprise Bankruptcy Law of 2006 states that a voluntary reorganisation petition can be made

when the company is not yet bankrupt but is likely to be bankrupt in the near future, which shows that a voluntary reorganisation filing does not require evidence that the company is already bankrupt. This has obviously been done to encourage rescue efforts to be made at as early a stage as possible. However, in the case of a creditor petition under Article 2 of the China Enterprise Bankruptcy Law of 2006, the bankruptcy tests (either cash flow or balance sheet) still apply at a time when the reorganisation petition is presented.

Apart from reorganisation filings by debtors or creditors, a reorganisation procedure can also emerge by converting an existing liquidation procedure into reorganisation. Under Article 70 of the China Enterprise Bankruptcy Law of 2006, in the event of an involuntary bankruptcy liquidation procedure (that is, the procedure was filed by a creditor), the debtor or its shareholders holding more than 10% of the company's equity can apply to the court to convert the liquidation to reorganisation and, if agreed, the reorganisation procedure will commence immediately thereafter. In practice only a very small number of cases are actually converted in this way. The vast majority of reorganisation filings are made either by the debtor or its creditors. It is worth emphasising that local government support is critical before any bankruptcy reorganisation filings will be seriously considered by courts.

As to whether the formal reorganisation procedure can be strategically used by companies to seek an orderly liquidation, this is generally impractical in China. Instead, it is frequently found that some government-backed company reorganisations are often changed into liquidation by the court when it is realised that the politically-motivated rescue task is not commercially and legally viable. The courts are considerably cautious when allowing the commencement of corporate reorganisations, making it rare to see reorganisations being used for liquidating companies in China. In fact, many reorganisations end up in liquidation due to reorganisation administrators' heavy reliance on finding a buyer to rescue the company; it frequently occurs that no buyer can be found. As occurs in many jurisdictions, once reorganisation has commenced there are really only two possibilities – either a successful rescue is concluded or the company collapses into liquidation.

The China Enterprise Bankruptcy Law of 2006 does not make provision for a threshold for entering the corporate reorganisation procedure. As already stated, no evidence of bankruptcy is required where the debtor itself files for reorganisation. However, this is in theory only as in practice in almost all existing cases the debtor must present evidence to prove that the company is balance-sheet bankrupt before the court opens the procedure. Where creditors file for reorganisation they will always have to prove either cash-flow or balance sheet insolvency before the court considers the petition.

In practice, there are courts that demand that the filing party must convince that the reorganisation proposal is very likely to be achieved. Some courts have also developed local solutions to screen corporate reorganisation filings, usually requiring that the rescue proposal must have been agreed in advance by some of the key stakeholders, including the secured creditors and sometimes even the potential buyers. This practical threshold of opening a corporate reorganisation procedure is set up and exercised by local courts on each case's own merits, although the consequence is that no legal certainty or consistency can easily be found in these circumstances.

Regarding the question as to whether directors are under an obligation to file for reorganisation when insolvency is imminent, under current insolvency and company

law in China it seems that directors are under no obligation to file for insolvency reorganisation in court. On the contrary, in many cases the company trades until the last money has been spent and the company's operations collapse.

### **6.5.3 Consequences of commencement**

The major benefit of entering into a formal reorganisation procedure is the imposition of a moratorium, which suspends all executions against the company and its assets. Importantly, the moratorium also binds secured creditors. As already noted above, the real concern regarding the moratorium is that although Article 19 of the China Enterprise Bankruptcy Law of 2006 states that all executions against the company must be stayed once the court accepts the reorganisation filing and begins the formal reorganisation procedure, some courts often refuse to withdraw the pre-existing asset-freezing orders against the company's particular assets.

For secured creditors, the moratorium may be lifted under Article 75 of the China Enterprise Bankruptcy Law of 2006 if the encumbered assets are likely to be substantially damaged, or the value of these assets are likely to decline sharply over a short period of time. In these circumstances the secured creditor may, with the leave of the court, sell the charged asset and receive payment immediately. However, this provision has not yet been tested in practice since determining the extent of the damage of the charged asset, or the extent of its declining value, may be very difficult. This provision is too subjective and a little vague to be used effectively in practice.

### **6.5.4 Appointment of bankruptcy administrator**

At the time when the reorganisation filing is accepted, a bankruptcy administrator (a qualified law or accounting firm) will simultaneously be appointed by the court. The bankruptcy administrator takes control of the company's assets and business affairs from the hands of the previous management. Neither the debtor nor the creditors have a say regarding the bankruptcy administrator's appointment, as this is in the exclusive discretion of the court. In theory Article 22 of the China Enterprise Bankruptcy Law of 2006 provides that in the subsequent reorganisation procedure the creditors may ask the court to replace the incumbent bankruptcy administrator. This can only be done where the court-appointed administrator is proved to be incompetent or biased, although one would struggle to find examples of this having happened in practice. It has been argued that creditors should be allowed to nominate a bankruptcy administrator, but the courts appear to be against such a proposal.

Although replacing an existing bankruptcy administrator in reorganisation is difficult to the point of being almost impossible, the position of the bankruptcy administrator can still be considerably weakened not by the creditors but by the debtor, since the debtor can apply for the debtor-in-possession model to be applied and, if approved by the court, the bankruptcy administrator will have to return control of the company to the debtor. In these circumstances the bankruptcy administrator in a reorganisation will only act as a reorganisation supervisor. Under Article 73 of the China Enterprise Bankruptcy Law of 2006, if a debtor-in-possession is sanctioned by the court, it is the debtor itself that steers the rest of the reorganisation operation, including the drafting of the reorganisation plan for creditors to vote on. The creditors do not have a say in making such a decision as this falls under the exclusive remit of the court.



In spite of the availability of the debtor-in-possession regime, in practice this is used in only a small percentage of cases. In most reorganisations it is the bankruptcy administrator who remains in control and manages the process until the end.

### **6.5.5 Powers and obligations of the bankruptcy administrator**

The main task of the bankruptcy administrator is to verify claims and to investigate the company's assets. Given that most corporate reorganisations in China routinely seek a sale, the bankruptcy administrator's key role is to co-ordinate between creditors and potential buyers so as to achieve a going concern sale of either the company as a legal entity or of the company's business.

In terms of Article 25 of the China Enterprise Bankruptcy Law of 2006, the bankruptcy administrator may exercise its own discretion in determining which assets should be sold. However, for some substantial assets, such as the buildings and the right to use of land, Article 69 of the China Enterprise Bankruptcy Law of 2006 requires that the bankruptcy administrator must report to the court or to the creditor committee, if one has been established, before taking any action to sell the assets. It should be noted that the obligation of the bankruptcy administrator is to report its decision to the court or to the creditor committee, not to get the permission of either of them before disposing of the assets. This does not make a lot of sense as it does not appear to restrict the power of the bankruptcy administrator in any way when dealing with the company's substantial assets. In practice, however, bankruptcy administrators tend to apply for an advance order from the court in order to protect themselves.

### **6.5.6 Post-commencement finance**

The China Enterprise Bankruptcy Law of 2006 does not contain any provisions allowing the bankruptcy administrator to tackle the illiquidity of the company in reorganisation by allowing it to borrow new money. This being the case, the law also does not provide for the super-priority status of post-reorganisation debt. However, there are some provisions contained in the law that are effectively used to circumvent this problem in practice.

Article 42 of the China Enterprise Bankruptcy Law of 2006 provides that if a company in a bankruptcy procedure (including reorganisation) continues to trade, the newly-generated employee wages, pension contributions and other post-bankruptcy debts are treated as bankruptcy expenses to be paid before all pre-bankruptcy creditors. So, in theory at least, the bankruptcy administrator may borrow new money and include this new debt as a category of post-bankruptcy debts to aid the reorganisation effort by offering *de facto* priority to the post-bankruptcy lender. In practice, lending to the company in reorganisation on this basis still creates some uncertainty. Over the past few years there has been litigation regarding the priority status of post-bankruptcy borrowing. Some courts respect the principle of post-bankruptcy borrowing forming part of the bankruptcy expenses and some do not. In order to protect themselves, many lenders ask for a special resolution of the creditors' meeting as well as the written approval of the court in order to clarify the priority status of any post-commencement lending before extending much-needed credit to the beleaguered debtor. This is one aspect of the law it is hoped will be clarified when the current law is amended.

### **6.5.7 Proof of claims by creditors**

For creditors to prove their claims, they must approach the reorganisation administrator and will usually be required to fill in a claim form provided by the administrator. In many cases, the reorganisation administrator will check the company's books and consult with staff from the company's financing unit for verification. In the event of a dispute over the legality or the accuracy of the claim, the creditor can litigate before the same court for a judgment, something that occurs regularly in practice. For the sake of efficiency, many courts arrange for an expedited process to resolve these law suits.

### **6.5.8 Reorganisation plan**

The reorganisation plan, which comprises either debt forgiveness or an equity adjustment arrangement, or both, must pass a vote by the creditors in order to be implemented. Under Article 81 of the China Enterprise Bankruptcy Law of 2006, the reorganisation plan must also include a business restructuring sub-plan, since reorganisation aims to revive, rather than to liquidate, the company's business. However, given that the majority of reorganisations rely on a sale rescue, in reality there are usually just very average reorganisation plans that do not really deal with business restructuring issues; these are largely left for the purchaser to deal with once the sale has gone through. In a practical sense, most creditors aim at obtaining a higher debt recovery by looking at whether the debt forgiveness is reasonably acceptable in conjunction with the dividend they will receive from the sale.

To vote on the proposed reorganisation plan, which is in most cases prepared by the bankruptcy administrator, Article 82 of the China Enterprise Bankruptcy Law of 2006 separates the creditors into four classes for voting purposes. These classes are i) secured creditors, ii) employees, iii) tax authorities and iv) ordinary unsecured creditors. Under Article 84 of the China Enterprise Bankruptcy Law of 2006, the reorganisation plan must be accepted by each class of creditors and should be voted in favour of by 50% or more of attending creditors in number whose claims represent two-thirds or more of the entire claims in each class. As regards voting in number, Chinese law only counts the number of creditors who attend the meeting, voting in person or by proxy. Absent creditors will not be counted, since absence from the meeting is deemed to be an abstention.

Apart from creditors eligible to vote on the reorganisation plan, Article 85 of the China Enterprise Bankruptcy Law of 2006 provides that in cases where the company's equity is affected, adjusted or cancelled by the reorganisation plan, it should also be voted on by the shareholders. The manner in which Article 85 has been drafted suggests that all reorganisation plans must also pass the vote of shareholders. This creates difficulties for reorganisation administrators, as many shareholders, in anticipation of the share cancellation in the reorganisation plan, either decline to attend the meeting to vote, or simply vote down the plan in protest. Considering the circumstances they have nothing to lose and so obtaining the co-operation of shareholders remains a challenge. Some insolvency scholars suggest that the vote of shareholders should be treated as advisory only, but unless the law changes the current issues with this will persist.

The approval of the reorganisation plan does not end after being voted on by the creditors (and shareholders, where required), as it must ultimately be confirmed by the court before taking effect. One of the more striking aspects of this duty of the court is that Article 87 provides that the court may cram-down a reorganisation plan that has been voted down by one or more class of creditors (or by the shareholders).

Unlike a reorganisation plan that has successfully passed the vote of all classes of stakeholders and that should generally only be assessed by the court for its procedural legality, a reorganisation plan seeking cram-down approval by the court must meet the statutory provisions of Article 87.

More specifically, Article 87 provides that for cram-down approval by the court, the reorganisation plan must:

- (a) be voted in favour of by the secured creditor class and, if not, secured creditors must be fully paid out of the secured assets (in addition to fair compensation for the delayed foreclosure);
- (b) be voted in favour of by the employee and tax authority classes and, if not, these two classes must be paid in full;
- (c) be voted in favour of by the ordinary unsecured creditor class and, if not, this class of creditors must not be paid less than they would have received under a liquidation procedure;
- (d) be voted in favour of by the shareholders where their equity is affected by the plan and, if not, the treatment of equity holders is fair and equitable;
- (e) pays the stakeholders in the same class fairly, with the priority between shareholders and creditors upheld; and
- (f) be feasible.

The essence of the aforementioned six conditions can be summarised as three tests, which is quite similar to the US practice under Chapter 11 of the US Bankruptcy Code. The first is the fair and equitable test, which requires the application of the *pari passu* principle between creditors in the same class. The second is the absolute priority test, requiring shareholders to be paid nothing unless and until creditors are paid in full. The priority order between these two groups of stakeholders must be respected, unless creditors as a whole agree otherwise. The third is the feasibility test, stating that the reorganisation plan should be achievable. Therefore, even if a reorganisation plan failed in the vote of any class of stakeholders, the court may still confirm it and forcibly approve the plan, making it legally binding on all consenting and dissenting stakeholders.

From statistics on existing corporate reorganisations in China, around a quarter of all reorganisation plans were crammed-down by the courts over the objections of creditors (and sometimes of shareholders).

In regard to the role of shareholders generally, they are obviously in a weak position in the context of a reorganisation procedure. Once the bankruptcy administrator is appointed, the company's management surrenders control of the company. Although Article 85 of the China Enterprise Bankruptcy Law of 2006 allows the representatives of shareholders to participate in the creditors' meeting when a reorganisation plan is deliberated, in practice most shareholders tend to remain absent due to the fact that it is almost certain that they will gain nothing due to the strict application of the absolute priority principle (especially in private company reorganisations). When the reorganisation of a listed company takes place the story is different, as the absolute priority principle is likely to be relaxed in the interest of shareholders (which will normally be a massive number of individual investors).

### **6.5.9 Executory contracts**

As regards executory contracts during reorganisation, under Article 18 of the China Enterprise Bankruptcy Law of 2006 the reorganisation administrator is obliged to either assume or reject any uncompleted contracts within two months after the commencement of the reorganisation procedure. An executory contract is deemed to be rejected if the reorganisation administrator remains silent on this issue for over two months or does not reply to a request from the contracting party for over 30 days. To protect the contractual party in this situation, Article 18 of the China Enterprise Bankruptcy Law of 2006 requires the bankruptcy administrator to provide security to the contracting party if an executory contract is assumed. In addition, in the event of the assumption of an executory contract Article 42 of the China Enterprise Bankruptcy Law of 2006 includes the debt arising from performing this contract as an expense in the reorganisation, giving it priority over all pre-bankruptcy claims. From this it is clear that the other party to an executory contract is well protected under the current bankruptcy law in China.

As stated above, claims by utility companies (such as water, gas and electricity suppliers) are difficult claims to deal with. These companies frequently demand priority payment for their pre-bankruptcy claims (which are unsecured) and threaten to cut the supply if their demands are not satisfied. As one can imagine, for some manufacturing companies the defaulted utility bills can be for very large amounts. Most reorganisation administrators tend to rely on courts that can request intervention by local government, given that most utility companies are state-owned.

Utility companies are not only aggressive in asserting their pre-bankruptcy claims but also impose more strict payment terms for post-bankruptcy bills, which are already treated as bankruptcy expenses because of the priority status. For example, ordinary businesses would normally pay their utility bills once a month; however, for companies in a reorganisation procedure the utility companies can request payment on a weekly basis, or even shorter periods of time.

### **6.5.10 Set-off**

In regard to the rules relating to set-off, there is no difference between liquidation and reorganisation. The creditor has the same rights and can request the reorganisation administrator to set-off what the company owes against the claim of the creditor.

### **6.5.11 Onerous contracts**

Regarding onerous contracts agreed by the company before bankruptcy, the reorganisation administrator can elect to reject the contract and any losses incurred by the third party will be included as an unsecured claim against the company in the reorganisation procedure.

### **6.5.12 Voidable transactions**

In dealing with transactions at an undervalue or as a preference, reorganisation administrators can exercise the same rights given to liquidation administrators (see above). Specifically, for transactions at an undervalue taking place within one year before the commencement of the reorganisation procedure, the reorganisation administrator can approach the court for an order to avoid them. Article 31 of the China Enterprise Bankruptcy Law of 2006 lists the categories of transactions at an undervalue that can be invalidated:

- (a) transferring assets to a third party as a gift or for no consideration;
- (b) entering into a deal priced unreasonably to the detriment of the company;
- (c) providing security for an unsecured claim;
- (d) paying a debt which was not due; and
- (e) giving up a debt.

For transactions as a preference, Article 32 of the China Enterprise Bankruptcy Law of 2006 provides that if the company was aware of its state of bankruptcy but still made payment to a creditor within six months before entering into the formal bankruptcy, including a reorganisation procedure, such a payment as a preference could be invalidated by the reorganisation administrator after obtaining a court order. However, this Article adds an exception: if the payment was made in the best interests of the company, this payment could be exempted from being voided.

In terms of potential pre-bankruptcy reckless or fraudulent trading, Article 25 of the China Enterprise Bankruptcy Law of 2006 only offers a general principle, stating that the company's directors, supervisors and senior management should be held accountable if the company's bankruptcy is caused by their breaches of the duty of care and diligence. In practice, very few people are disciplined under this Article. Holding delinquent directors and management responsible is arguably not at the top of the agenda of either the courts or reorganisation administrators.

#### **6.5.13 Distribution rules**

As regards payment to creditors in a reorganisation procedure, under Article 87 of the China Enterprise Bankruptcy Law of 2006 this is entirely subject to the negotiation of a rescue plan. By contrast, in a liquidation, *pari passu* distribution is compulsory between creditors and the absolute priority between creditors and shareholders should also be firmly complied with. However, should the reorganisation plan proposed by the reorganisation administrator be voted down by one or more class of creditors, under Article 87, if the non-consensual reorganisation plan seeks for a forcible confirmation by the court, both the *pari passu* and absolute priority principles must be followed.

In practical terms, secured creditors are paid out of the realisation of the charged assets and, after meeting the administration expenses (including the administrator's fees), the employee claims are paid as the first preferential class, followed by the tax authorities as the second preferential class, with the surplus, if any, going to ordinary unsecured creditors. In most cases, shareholders get nothing due to the insolvency of the company in reorganisation. This order of payment is mostly respected in practice.

#### **6.5.14 Groups of companies**

For group company reorganisations, there are generally two approaches arising from practice. One is to substantially consolidate all companies in the group as one case, with the legal personality of each company within the group invalidated and the group of companies are handled as one legal person in reorganisation. This is controversial but is widely practised in China. The China Enterprise Bankruptcy of 2006 says little about this, but many courts have developed this approach due to practical considerations. By contrast, some courts tend to take a conservative approach, firmly

respecting the legal personality boundaries between the companies within a group and only procedurally handling the reorganisation of all companies in a group for administrative convenience.

### 6.5.15 Special treatment for SMEs

Finally, regarding special procedures for SME reorganisations, currently insolvency law in China does not yet provided any detailed guidance on this issue. However, given that there are a growing number of bankruptcy reorganisations in China, some tailored procedures for SME reorganisations may emerge in the near future.

#### Self-Assessment Exercise 5

##### Question 1

Briefly describe the two control models of the company reorganisation procedure under the current China Enterprise Bankruptcy Law of 2006.

##### Question 2

Analyse reorganisation administrator appointments under the China Enterprise Bankruptcy Law of 2006 as well as potential replacement requests by creditors.

##### Question 3

How do Chinese courts deal with the reorganisation of groups of companies? Describe the two approaches developed from practice.

**For commentary and feedback on self-assessment exercise 5, please see APPENDIX A**

## 7. CROSS-BORDER INSOLVENCY LAW

China has not adopted the UNCITRAL Model Law on Cross-Border Insolvency and it seems there is little political will to do so in the foreseeable future, given that China is strongly promoting nationalism under its current leadership. But it is fair to say that when the China Enterprise Bankruptcy Law of 2006 was drafted, some draftsmen were influenced by the publication of the UNCITRAL Model Law on Cross-Border Insolvency, so it is not really surprising to see that the China bankruptcy law embraces some of the principles of universality in dealing with cross-border insolvencies.

Article 5 of the China Enterprise Bankruptcy Law of 2006 states that a Chinese court bankruptcy ruling binds the company's assets located anywhere in the world, implying that any assets outside China are also subject to the bankruptcy procedure in China. This aggressive approach is criticised by many Chinese bankruptcy commentators, suggesting that this clause is unrealistic; unless a Chinese bankruptcy order is recognised by a foreign court, it would be unenforceable in a foreign country.

Equally, Article 5 also provides that a foreign court bankruptcy ruling also binds the company's assets located in China. However, for a foreign court bankruptcy ruling Article 5 adds some restrictions, stating that the foreign bankruptcy court ruling must be recognised by a Chinese court before taking effect in China and that the recognition should be based either on a judicial assistance treaty signed and ratified between China and the requesting country, or on the principle of reciprocity if there is no treaty. In the meantime, Article 5 includes some routine public interest reservations, providing that the recognition of a foreign court bankruptcy ruling should not infringe upon the fundamental principles of Chinese law, China's sovereignty, security and public interests and does not disadvantage China's domestic creditors.

It is worth highlighting that for a foreign court bankruptcy ruling to be recognised in China, a judicial assistance treaty with China is essential. As of 2015, around 30 countries have concluded the required treaty with China, including Argentina, Belgium, Bulgaria, France, Hungary, Italy, Morocco, Singapore, South Korea, Spain, Thailand, Tunis, the United Arab Emirates, Belarus, Cyprus, Cuba, Egypt, Greece, Kazakhstan, Kyrgyzstan, Laos, Lithuania, Mongolia, North Korea, Poland, Rumania, Russia, Tajikistan, Turkey, Ukraine, Uzbekistan and Vietnam.

Under Chinese civil procedure law, the party seeking recognition of a foreign bankruptcy judgment would have to do so in a Chinese local intermediate people's court, where the company's assets are located.

As for judicial reciprocity, the Chinese judicial system takes the view that the foreign country must already have had a recognition precedent in favour of a Chinese party in the first place and that Chinese courts may not recognise a foreign bankruptcy judgment in the absence of a prior favourable recognition in the interest of a Chinese party. In other words, from the point of view of the Chinese court system, establishing reciprocity must be initiated by the foreign country. The Chinese judicial system will never extend judicial hospitality if the foreign country does not take the first step. Many commentators argue that, given China's growing role in the international trade and investment system, China should consider unilaterally initiating the establishment of reciprocity so as to facilitate judicial co-operation in this regard.

Unfortunately, any discussion of judicial collaboration between China and foreign countries seems to be irrelevant in practice. Up to now, there are only a handful of foreign bankruptcy procedures that have been recognised in China. Many of the Chinese courts are still reluctant to accept a foreign court bankruptcy ruling in the belief that doing so may weaken Chinese judicial sovereignty. Another factor would be that judges are considerably nervous in dealing with cases with foreign elements.

In 2001, shortly before Chinese accession to the WTO, the Foshan Intermediate People's Court, Guangdong Province, recognised a bankruptcy ruling issued by the court of Milan in Italy. This is the only recorded recognition in Chinese bankruptcy law history and that case was more or less politically motivated, since at that time China used it to demonstrate its open-mindedness in order to impress its (prospective) WTO partners.

In 2005, the Guangzhou Intermediate People's Court recognised a bankruptcy procedure from France, paving the way for the French liquidator to smoothly dispose of the company property located in China, since the local property registration authority insisted that the legal status of the French liquidator must be recognised by a local Chinese court, otherwise his action in selling the company's assets in China would not be acknowledged as legitimate.

In 2012, the Wuhan Intermediate People's Court recognised a bankruptcy procedure from Germany on the basis of reciprocity, facilitating the German liquidator to dispose of the company's assets in Wuhan. Interestingly, in this case the Wuhan court ironically did not rely on Article 5 of the China Enterprise Bankruptcy Law of 2006 to entertain the request of the German liquidator. Instead, the Wuhan court relied on Article 282 of the China Civil Procedure Law of 1991 to support the German liquidator's asset disposal efforts in China.

Apart from the three recognition cases above, it seems that no other foreign office-holders have been lucky enough to have been recognised in China.

In 2016 there was a high profile international case, when Hanjin Shipping Limited entered into a court-involved bankruptcy rehabilitation procedure in South Korea. Although this ruling was recognised in many jurisdictions, including the US, UK, Australia and Singapore, there is unfortunately no evidence to suggest that this ruling was recognised in China. This resulted in many Hanjin vessels in Chinese waters being seized by order of the Chinese maritime courts, which made the rehabilitation efforts in South Korea significantly more difficult.

For someone seeking recognition of a Chinese corporate bankruptcy ruling abroad, this will depend on the domestic law of the foreign country. If the foreign country has adopted the UNITRIAL Model Law on Cross Border Insolvency, seeking recognition would of course be a far easier undertaking. For example, there has already been a recognition case in which a Chinese court bankruptcy reorganisation ruling, issued by the Jiaxin Intermediate People's Court in Zhejiang Province for the company Zhejiang Topoint Photovoltaic Limited, which was recognised by the New Jersey District Bankruptcy Court in the US on 16 July 2014. Potentially, an American company could in future apply to a Chinese court for the recognition of a US bankruptcy ruling by citing the fact that the US has provided judicial reciprocity to China.

It is worth noting that foreign creditors / shareholders are treated in the same way Chinese domestic creditors / shareholders are treated. Under the current China Enterprise Bankruptcy Law of 2006, there is no preference given to domestic creditors over foreign ones.

In sum, most Chinese courts are considerably cautious in accepting or entertaining foreign bankruptcy recognition applications and China has not yet created a friendly environment for foreign bankruptcy rulings to be accepted.

### Self-Assessment Exercise 6

#### Question 1

Explain the statutory conditions for a foreign court bankruptcy ruling to be recognised by a Chinese court.

#### Question 2

Briefly explain why seeking the recognition of foreign court bankruptcy rulings is still very difficult in China.



**For commentary and feedback on self-assessment exercise 6, please see APPENDIX A**

## 8. RECOGNITION OF FOREIGN JUDGMENTS

The recognition of foreign judgments in China is generally governed by Chinese civil procedural law. In particular, Chapter 27 of the China Civil Procedure Law of 1991 is devoted to international judicial co-operation. Given that China is not a common law jurisdiction, these issues largely rely on legislative provisions rather than on precedents. Needless to say, presenting evidence of previously successful cases may help persuade judges to issue a favourable recognition ruling, even though these cases are not legally binding.

Under Article 281 of the China Civil Procedure Law of 2007, a foreign judgement that is sought to be recognised in China must be final and conclusive. The recognition application can be made directly by the interested party to a Chinese local intermediate people's court where the disputed assets are located, or where the defendant is domiciled, or by a foreign court on behalf of the parties in dispute (if applicable).

But Article 282 of this law makes clear that recognising a foreign judgement is conditional upon that the foreign country having a judicial assistance treaty with China and, if not, reciprocity must already have been established between the two jurisdictions. As already noted, some 30 countries already have such treaties with China. Unfortunately, China's two biggest trading partners, the USA and Japan, have not yet signed any judicial assistance treaties with China.

As regards reciprocity, the general attitude in China is that there must be an existing recognition ruling by the foreign court in favour of a Chinese court judgment. In principle, Chinese courts may not unilaterally recognise a foreign judgment as the first step to establishing reciprocity with a foreign jurisdiction.

In addition to the existence of a judicial treaty or reciprocity, Article 82 adds that the court may reject the recognition application if the foreign judgement violates the fundamental principles of Chinese law, sovereignty, security or the public interest. However, unlike many other jurisdictions, the China Civil Procedure Law of 1991 does not elaborate on what these fundamental legal principles of Chinese law really are. In addition, the concepts of Chinese sovereignty, security and public interest have also not yet been unequivocally defined.

Compared to the difficulties involved with the recognition of foreign judgements, the Chinese judicial system is more pro-active in promoting the recognition of foreign arbitration results. This seems to be a judicial priority in China, especially given China's current status in respect of international trade. Article 283 of the China Civil Procedure Law of 1991 stipulates that a recognition application for a foreign arbitration result may be lodged directly with a Chinese local intermediate people's court where the defendant has its domicile or where its assets are located. The Chinese courts will recognise an arbitration verdict if there is a judicial assistance treaty between China and the foreign country, or if reciprocity has already been established. Unlike the case in recognising foreign judgments, Article 283 of the China Civil Procedure Law of 1991 does not include the public interest clause when

recognising a foreign arbitration result, suggesting that China may have a pro-arbitration policy.

In practice, most foreign judgment recognition applications are rejected by the Chinese courts. In many cases, Chinese courts simply reject applications on the grounds that there is no judicial assistance treaty, or that reciprocity has not been established. In cases where the disputed party can prove there is a treaty or reciprocity, many Chinese courts seek some procedural defects to reject the recognition request. For example, some courts in China frequently quote the fact that judicial notices in foreign countries are not delivered in person and are not returned with a signature from the receiving party, which is contrary to Chinese domestic judicial practice.

Up until 2013, apart from the aforementioned recognition of an Italian bankruptcy order, a local Guangdong intermediate people's court recognised a court bankruptcy judgment from France in 2005. In 2012, a German bankruptcy ruling was recognised in Wuhan, China.

Some commentators also point out that although China's authorities publicly announce its political support for the recognition of foreign arbitration results, practice seems to suggest that the Chinese courts are probably as wary of recognising foreign arbitration results as they are in recognising foreign court judgments.

In sum, the general principles of recognising foreign judgements are clearly articulated in Chinese civil procedure law, but due to political, social and judicial constraints, it is rare for foreign judgments to be successfully recognised by Chinese courts. This is something that international businesses must bear in mind when dealing with their business partners in China. In some cases, foreign partners will have no option but to use the Chinese courts to settle disputes.

### Self-Assessment Exercise 7

#### Question 1

Briefly discuss the statutory requirements for a foreign judgment to be recognised in China.

#### Question 2

Are there any differences between recognising a foreign judgment and a foreign arbitration award under Chinese law?

**For commentary and feedback on self-assessment exercise 7, please see  
APPENDIX A**

## 9. INSOLVENCY LAW REFORM

In recent years, under pressure from the international community (especially the US) to comply with WTO rules, China promised to improve the implementation of the China Enterprise Bankruptcy Law of 2006 in order to provide an orderly exit for failed enterprises. However, it is unfortunate that the real efforts in practice deviate considerably from the verbal promises made, with the Chinese central government, including the China Supreme People's Court, announcing its determination to use the bankruptcy law to wind up so-called "zombie" companies, most of which are money-losing State-owned Enterprises (SOEs). There appears to be little political will to vigorously implement the China bankruptcy law to enhance legal certainty and predictability for the business community as a whole in China. To a large extent, the new enterprise bankruptcy law of 2006 is still a legislative tool for the Chinese government to administratively reform its state sector. But for ordinary businesses, a properly functioning bankruptcy law is largely unavailable in China.

In 2015, when the China Supreme People's Court amended its judicial notice on the implementation of the China civil procedure law, the previous practice of using the *pari passu* principle in judgment execution against legal person execution debtors, was abolished. This move was supposed to boost the use of China's bankruptcy law and simultaneously ease the large number of commercial execution judgment dockets in the courts.

However, this change only brought about limited success. In 2017, the national number of enterprise bankruptcy cases rose to almost 10,000. This may seem to indicate success, but it is estimated that 90% of all enterprises that are bankrupt and should enter a bankruptcy procedure to exit the market, do not, or are not allowed to, use the court-involved bankruptcy procedures. Implementation of China's bankruptcy law therefore remains weak.

Generally speaking, the thin rule of law and the heavy involvement of courts may be two major factors hindering the effective implementation of the Chinese bankruptcy system. A market-based corporate bankruptcy system seems to be needed if China really intends to build an effective corporate bankruptcy law system to protect investors by giving them legal certainty and predictability. This is easier said than done.

## 10. USEFUL ADDITIONAL INFORMATION

There are two books exclusively shedding light on the China corporate bankruptcy law:

- Rebecca Parry, Yongqian Xu and Haizheng Zhang (eds), *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Ashgate, 2010);
- Zinian Zhang, *Corporate Reorganisations in China: An Empirical Analysis* (Cambridge University Press, 2018).

Some journal articles and book chapters would be helpful in understanding the China corporate bankruptcy law both in the books and in action:

- Arsenault, Steven J, "The Westernization of Chinese Bankruptcy: An Examination of China's New Corporate Bankruptcy Law through the Lens of the

UNCITRAL Legislative Guide to Insolvency Law” (2008) 27 *Penn State International Law Review* 45;

- Arsenault, Steven J, “Leaping over the Great Wall: Examining Cross-Border Insolvency in China under the Chinese Corporate Bankruptcy Law” (2011) 21 *Indiana International & Comparative Law Review* 1;
- Bendapudi, Ravi, “People’s Republic of China Bankruptcy Law” (2008) 6 *Santa Clara Journal of International Law* 205;
- Booth, Charles D, “The 2006 PRC Enterprise Bankruptcy Law: The Wait is Finally Over” (2008) 20 *Singapore Academy of Law Journal* 275;
- Carruthers, Bruce G and Terence C Halliday, “Negotiating Globalization: Global Scripts and Intermediation in the Construction of Asian Insolvency Regimes” (2006) 31 *Law & Social Inquiry* 521;
- Falke, Mike, “China’s New Law on Enterprise Bankruptcy: A Story with a Happy End?” (2007) 16 *International Insolvency Review* 63;
- Parry, Rebecca and Haizheng Zhang, “China’s New Corporate Recue Laws: Perspectives and Principles” (2008) 8 *Journal of Corporate Law Studies* 113;
- Rapisardi, John J and Binghao Zhao, “A Legal Analysis and Practical Application of the PRC Enterprise Bankruptcy Law” (2010) 11 *Business Law International* 49;
- Ren, Yongqing, “Wealth Distribution in Chinese Bankruptcy Reorganization Law and Practice” (2011) 20 *International Insolvency Review* 91;
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- Shi, Jingxia, “Chinese Cross-Border Insolvencies: Current Issues and Future Developments” (2001) 10 *International Insolvency Review* 33;
- Tomasic, Roman and Zinian Zhang, “The Political Determinants of Corporate Reorganization in China” in Christoph Antons (ed), *Routledge Handbook of Asian Law* (Routledge, 2015);
- Wang, Weiguo, “Adopting Corporate Rescue Regimes in China: a Comparative Survey” (1998) 9 *Australian Journal of Corporate Law* 234;
- Woodward, William J Jr, “‘Control’ in Reorganization Law and Practice in China and the United States: An Essay on the Study of Contrast” (2008) 22 *Temple International & Comparative Law Journal* 141;
- Xie, Bo, “The Two-Pronged Model for Control of Corporate Reorganizations under Chinese Reorganization Procedure: Application, Problems and Improvement” (2013) 24 *International Company and Commercial Law Review* 104;

- Zhang, Xianchu and Charles D. Booth, “Chinese Bankruptcy Law in an Emerging Market Economy: The Shenzhen Experience” (2001) 15 *Columbia Journal of Asian Law* 1;
- Zhang, Zinian and Roman Tomasic, “Corporate Reorganization Reform in China: Findings from an Empirical Study in Zhejiang” (2016) *Asian Journal of Comparative Law* 55;
- Zhang, Zinian, “Corporate Reorganizations of China’s Listed Companies: Winners and Losers” (2016) 16 *Journal of Corporate Law Studies* 101;
- Zhao, Huimiao, “Reorganization of Listed Companies with Chinese Characteristics” (2017) 91 *American Bankruptcy Law Journal* 87;
- Godwin, Andrew, “Corporate Rescue in Asia – Trends and Challenges” (2012) 34 *Sydney Law Review* 163.

**APPENDIX A: COMMENTARY AND FEEDBACK ON SELF-ASSESSMENT EXERCISES****Self-Assessment Exercise 1****Question 1**

Briefly explain China's two debt collection systems.

**Question 2**

Can an execution officer in China seize and sell the commercial buildings of the execution debtor to meet a judgment payment? If so, what are the difficulties when the execution officer attempts this method of enforcement?

**Question 3**

Does the China Enterprise Bankruptcy Law of 2006 apply to the bankruptcy of sole traders who have no independent legal status?

**Question 4**

Does the China Supreme People's Court directly hear corporate bankruptcy cases? Explain the company bankruptcy work allocation between the courts at the different levels in China.

**Commentary and Feedback on Self-Assessment Exercise 1****Question 1**

For creditors in China, there are two formal debt collection systems to protect them: one is the individual debt collection system and the second the bankruptcy debt collection system. To use the individual collection system, creditors can sue debtors before a court, and initiate a judgment execution procedure following obtaining a winning judgment. This is the most used debt collection tool in China.

The second bankruptcy, collective debt collection system is legally available, though in practice it is difficult, but not impossible, to open a bankruptcy procedure in court. A bankruptcy collection system will serve the creditors of a debtor as a whole, and the realised assets will be in principle distributed to creditors under the *pari passu* principle.

**Question 2**

Execution officers can sell the commercial buildings of a judgment debtor and in fact all of the debtor's assets can be subject to an execution demand. To sell a commercial building, many execution officers face two major difficulties. The first is that if the debtor company is maintaining business operation, an execution officer will be reluctant to force a sale, since local government may not support such a destructive and forceful action. The second is that many commercial buildings do not have proper legal documents, and that the difficulty in legally transferring ownership may deter potential buyers.

**Question 3**

The China Enterprise Bankruptcy Law of 2006 only applies to the bankruptcy of enterprises which have an independent legal status. Sole traders do not have an independent legal status under Chinese law and the traders themselves must ultimately bear the debts of the business, so they are not eligible to the use of the China Enterprise Bankruptcy Law of 2006.

**Question 4**

The China Supreme People's Court has never directly heard corporate bankruptcies, and of course it can handle such cases if it wants.

To choose a court to file company bankruptcy, the petition should be submitted to a court in whose jurisdiction the debtor company is domiciled; then the petitioner must check at which level offices of the China Industries and Commerce Regulation Bureau the debtor company is registered. If the debtor is registered as a county office of the China Industries and Commerce Regulation Bureau, the bankruptcy case should be heard at a local county people's court. If the registration authority is at above the county level, for example, at the local provincial office of the China Industries and Commerce Regulation Bureau, the bankruptcy of such a company should be heard at the local intermediate people's court.

**Self-Assessment Exercise 2****Question 1**

Explain the three forms of securities recognised under the China Property Law of 2007.

**Question 2**

Explain how to realise a fixed charge in China's courts.

**Question 3**

Between charges, pledges and liens, which form of security is used the most in the commercial world in China?

**Commentary and Feedback on Self-Assessment Exercise 2****Question 1**

There are three basic forms of securities in China: fixed changes, pledges and liens. A fixed charge can be created upon buildings or the use right of land, and must be registered. A pledge can be made upon assets such as shares, trademarks and patents, but also must be registered at relevant authorities. Liens are rarely used and almost commercially irrelevant in China.

**Question 2**

To realise a fixed charge, the charge holder can sell the charged asset with the consent of the asset owner in advance. If the asset owner does not give consent (and in most cases there is no consent), the charge holder has to resort the second option: litigation followed by judgment execution. In fact, fixed charges are routinely realised through the second option in China. The charge holder has to sue the chargor, and then initiates a judgment execution procedure in which the court will sell the charged asset.

**Question 3**

Although there are three forms of securities, fixed charges remain the most used. Banks frequently demand fixed charges on the use right of land and buildings for security. Pledges upon assets such as shares are used less often. Liens are more or less commercially irrelevant in China.

**Self-Assessment Exercise 3****Question 1**

Given that in China there is no personal bankruptcy law, how can creditors seek fairness under the current legal landscape?

**Question 2**

Explain the limitations on *pari passu* distribution in judgment executions in China.

**Commentary and Feedback on Self-Assessment Exercise 3****Question 1**

There is no personal bankruptcy law in China currently and this means that if a personal debtor is unable to pay debt that is due, no court-involved bankruptcy procedure can be opened to realise his assets for the fairness of creditors as a whole. Under the current law in China, creditors can use the individual debt collection system to seek fairness. An execution creditor can petition to a court which has seized the debtor's substantial assets on behalf of a third creditor for fair distribution. Fair distribution means that the available assets of the common debtor will be paid *pari passu* to all execution creditors. In this way, creditors are served fairly.



**Question 2**

*Pari passu* distribution in judgment execution has two limits. First, only execution creditors are allowed to join the distribution and this means that if a creditor does not take legal action by suing the debtor and initiating a judgment execution procedure afterwards, joining a fair distribution is not allowed. This means that a very limited number of creditors can benefit from fair distribution. Second, execution officers usually have no powers to investigate the debtor's assets and in most cases only the debtor's buildings or the use right of land could be realised for distribution, which means that only a limited range of assets could be available for fair distribution. These two limits undermine the effectiveness of fair distribution in judgment execution in China.

**Self-Assessment Exercise 4****Question 1**

What types of businesses are eligible to use the China Enterprise Bankruptcy Law of 2006?

**Question 2**

How can a bankruptcy liquidation procedure be converted into a reorganisation procedure under the current Chinese bankruptcy law?

**Question 3**

Can director disqualification be exercised in a practical manner under the China Enterprise Bankruptcy Law of 2006?

**Question 4**

Explain the two main approaches in dealing with the bankruptcy of company groups in China.

**Commentary and Feedback on Self-Assessment Exercise 4****Question 1**

Only enterprises having independent legal status are eligible to use the China Enterprise Bankruptcy Law of 2006. Individuals and businesses registered as sole traders are not allowed to use this law for a court-involved bankruptcy procedure. Partnerships are also not allowed to use this law.

**Question 2**

If there is an involuntary liquidation procedure filed by a creditor, the debtor or its shareholders holding 10% or more of the company's equity can petition the court for the conversion into reorganisation. Upon approval by the court, liquidation will be changed to reorganisation. Although the law allows for such a conversion, it is not frequently used in China.

**Question 3**

Under the current law in China, bankruptcy administrators must investigate the causes of bankruptcy and hold culpable directors or senior managers accountable. But in practice, it is rare to see bankruptcy administrators investigating any pre-bankruptcy misconduct committed by directors.

**Question 4**

For the bankruptcy of company groups, there are two ways of consolidating the related bankruptcies. The first is procedural consolidation. This means the bankruptcies of individual companies within a group are procedurally handled in the same court and by the same bankruptcy administrator, but each individual company is still treated as an independent legal entity, having its own creditors and assets. Procedural consolidation is only for administrative convenience. By contrast, the second method is substantial consolidation, by which the group of companies is treated as one single legal entity and the independent legal status of each company within the group is revoked. In substantial consolidation, creditors have claims against the group of companies, rather than against a particular company as before.

**Self-Assessment Exercise 5****Question 1**

Briefly describe the control models of the company reorganisation procedure under the current China Enterprise Bankruptcy Law of 2006.

**Question 2**

Analyse reorganisation administrator appointments under the China Enterprise Bankruptcy Law of 2006 as well as potential replacement requests by creditors.

**Question 3**

How do Chinese courts deal with the reorganisation of groups of companies? Describe the two approaches developed from practice.

**Commentary and Feedback on Self-Assessment Exercise 5****Question 1**

There are two control models in a corporate reorganisation procedure under the current China Enterprise Bankruptcy Law of 2006. The first is a default one: administrator-in-possession. Upon the commencement of a reorganisation procedure, the court will appoint an administrator to take control of the company's assets and business affairs. The court-appointed administrator is in charge of the whole reorganisation process. However, to make a rescue mission more feasible, the China Enterprise Bankruptcy Law of 2006 allows the debtor to apply for debtor-in-possession after the formal reorganisation procedure begins. If approved by the court, the debtor can regain control under the debtor-in-possession model, and in this situation the court-appointed administrator will retreat to be a supervisor only. In practice, the majority use administrator-in-possession, and a small proportion of reorganisations resort to debtor-in-possession.

**Question 2**

When a court decides to open a reorganisation procedure, it routinely appoints an administrator to manage the whole rescue process. Creditors and debtors are not allowed to appoint reorganisation administrators. However, to allow creditors' voices to be heard, the China Enterprise Bankruptcy Law of 2006 permits creditors to request a replacement of the incumbent administrator on the condition that there is evidence of incompetence or partiality. Creditors can ask for a replacement but are not allowed to directly appoint an alternative administrator.

**Question 3**

There are generally two approaches in dealing with the bankruptcy of a company group. The first is procedural consolidation, by which the bankruptcy of all companies within the same group will be handled by the same court and perhaps by the same administrator, but each company is still treated as an independent legal entity. Procedural consolidation is only for administrative convenience. By contrast, the second approach is substantial consolidation, and the group of companies are treated as a single legal entity, with the independent status of each company within the group removed. Creditors can file claims against the group as a whole rather than against a particular company as before. Usually, before the use of substantial consolidation, the bankruptcy administrator may seek approval from the court.

**Self-Assessment Exercise 6****Question 1**

Explain the statutory conditions that apply for a foreign court bankruptcy ruling to be recognised by a Chinese court.

**Question 2**

Briefly explain why seeking the recognition of foreign court bankruptcy rulings is still very difficult to achieve in China.

**Commentary and Feedback on Self-Assessment Exercise 6****Question 1**

Under Article 5 of the China Enterprise Bankruptcy Law of 2006, a foreign bankruptcy ruling can be recognised in China if some assets are located there. To seek recognition, the foreign bankruptcy representative must check whether there is a judicial assistance treaty between China and that foreign country over civil and commercial matters. Having a treaty is essential for a foreign bankruptcy ruling to be recognised in China. At present, there are around thirty countries having such treaties with China. If there is no treaty, it is still possible to seek recognition and the foreign bankruptcy representative needs to prove that there is judicial reciprocity between China and that foreign country.

**Question 2**

Generally there are two obstacles in seeking recognition of a foreign bankruptcy ruling. The first is that there must be a judicial treaty over civil and commercial matters between China and the foreign country before a recognition application can be considered by a Chinese court. At present, there are only around thirty countries having such treaties with China, and unfortunately China does not have such a treaty with its two biggest trading partners, the USA and Japan. The second is that if there is no treaty the foreign bankruptcy representative must convince the Chinese court that there is judicial reciprocity established between China and the foreign country. More importantly, the Chinese understanding of reciprocity is very restrictive: reciprocity is not established until and unless there is already a Chinese judgment recognised by that foreign country before. In other words, reciprocity is very narrowly interpreted in China, which makes the recognition of foreign bankruptcy rulings more difficult.

**Self-Assessment Exercise 7****Question 1**

Briefly discuss the statutory requirements for a foreign judgment to be recognised in China.

**Question 2**

Are there any differences between recognising a foreign judgment and a foreign arbitration award under Chinese law?

**Commentary and Feedback on Self-Assessment Exercise 7****Question 1**

For a foreign judgment to be recognised in China, the applicant must prove that there is a judicial assistance treaty over civil and commercial matters between China and the foreign country in which the judgment is produced. There are around thirty countries having signed such treaties with China at present. If there is no treaty, a foreign judgment can still be recognised in China if the applicant can prove that there is judicial reciprocity established between China and the foreign country. The Chinese way of understanding and practicing reciprocity is rather unique. Reciprocity is non-existent unless and until there is a Chinese judgment recognised in that foreign country and Chinese courts rarely take the first step to exercise reciprocity or comity. Without the existence of a treaty or reciprocity, it is very unlikely that a foreign judgment will be recognised in China and the applicant will have no option but to initiate new litigation in China.

**Question 2**

Compared with the recognition of foreign judgments, China has a more liberal policy in recognising foreign arbitral awards. China has signed more international treaties on recognising foreign arbitral awards and in most cases foreign parties can rely on treaties to seek recognition in Chinese courts. To prevent local courts from abusing their powers, the China Supreme People's Court requires that if a foreign arbitral award recognition is rejected, consent from the China Supreme People's Court must be obtained. This essentially means that for Chinese courts rejecting a foreign arbitral award application is more difficult and it is a considerable advantage for foreign parties. Unfortunately, such an advantage is not available for foreign parties seeking foreign judgment recognition.



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