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ARTICLE

The Balance of Power in Insolvency Proceedings: The Case of China

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Introduction

The purpose of this paper is to examine the implementation of the new Chinese Enterprise Bankruptcy Law 2006 with a particular eye to the roles and functions of the China's judiciary in the legal framework, and to identify possible operational weaknesses arising from role of the Chinese courts in this area. The 2006 Law was a significant milestone, replacing a law that had been introduced in 1986 for trial implementation, since it was the culmination of a reform process that was decades long.[1] The new law, for the first time, introduces a unified system of insolvency laws, applying to both SOEs, who were previously been dealt with under the 1986 law,[2] and private enterprises, which had been the subject of a limited range of bankruptcy provisions under Chapter XIX of the Civil Procedure Law 1991.[3] Another significant aspect of the 2006 law is that it removes elements of state control which were present in the 1986 law, although it is arguable that state control may still be exerted through other means.

Several factors lay behind the introduction of the new law. The economy has changed significantly since 1986 with private enterprises playing an increasingly important role and state owned enterprises having been reformed and no longer dominating the market.[4] In addition, the absence of effective insolvency laws was noted by the European Union in refusing to recognise China as having market economy status.[5] The provision of bankruptcy laws is regarded as a necessary feature of a market economy, since, under such a system, the future of a company is decided by market forces, rather than by state intervention.

The Chinese reforms can be viewed as part of a significant wave of reforms to domestic laws and greater international cooperation,[6] timely reforms in view of the current economic climate. However the design of

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1 Literature discussing the new law includes R. Parry, Y. Xu and H. Zhang (eds), *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Ashgate Publishing, Farnham, 2010); J. Shi, 'Twelve Years to Sharpen One Sword: The 2006 Enterprise Bankruptcy Law and China's Transition to a Market Economy' (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 645, 652; M. Falke, 'China's new law on enterprise bankruptcy: a story with a happy end?' (2007) 16 *International Insolvency Review* 63; R. Parry and H. Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113; H. Bufford, 'The New Chinese Bankruptcy Law: Text and Limited Comparative Analysis' (2007) 16 *Norton Journal of Bankruptcy Law and Practice* 697; and L. Qi, 'The corporate reorganization regime under China's new enterprise bankruptcy law' (2008) 7 *International Insolvency Review* 13; C. Booth, 'The 2006 PRC Enterprise Bankruptcy Law: the Wait is Finally Over' (2008) 20 SAcLJ 275.

2 Adopted at the 18th Meeting of the Standing Committee of the Sixth National People's Congress and Promulgated by Order No. 45 of the President of the People's Republic of China, December 2 1986. English translation at www.novexcn.com/enterprise_bankruptcy.html accessed on 29 January 2008 and D. Boshkoff and Y. Song, 'China's New Bankruptcy Law: A Translation and Brief Introduction' (1987) 61 *American Bankruptcy Law Journal* 359. See Ta-Kuang Chang, 'The Making of the Chinese Bankruptcy Law: A Study in the Chinese Legislative Process' (1987) 28 *Harvard International Law Journal* 333 on the background to this law and Z. Xiao, 'China's Bankruptcy Law: Socialist in Characteristic, Capitalist in Methods' (1989) 10 *Company Lawyer* 58.

3 Separate bankruptcy laws were also applicable in the economically developed 'special economic zones', including Shenzhen, Zhuhai, Shantou, Xiamen and Hainan. An example is the Shenzhen Enterprise Bankruptcy Regulations, enacted in 1993.

4 R. Parry and H. Zhang, 'China's New Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113, 120 to 121.

5 Although the introduction of the new bankruptcy law was praised by EU Trade Commissioner Peter Mandelson in a speech of 10 July 2007, he added that there was progress to be made in removing barriers to access to the Chinese market and in the protection of intellectual property requirements and so there was some way to go before market status recognition could be given. See <ec.europa.eu/commission_barroso/mandelson/speeches_articles/sppm162_en.htm>.

6 See K. Gromek Broc and R. Parry (eds), *Corporate Rescue, An Overview of Recent Developments from Selected Countries in Europe* (Kluwer, The Hague, 2004) and K. Gromek Broc and R. Parry (eds), *Corporate Rescue: An Overview* (Kluwer, Alphen aan den Rijn, Netherlands, 2006) for chapters outlining recent developments in several countries.

such laws is a matter of great technical difficulty and legislatures across the world have struggled to devise optimal laws. In reform processes attention has been paid to effective governance structures and achieving an appropriate balance between the interests of different stakeholders affected by the insolvency. This article will consider the approach taken in China to the allocation of power to the administrator, the courts and to different interest groups, namely: secured creditors, unsecured creditors and employees. The rights and obligations of each will be considered as part of this process. However initially a brief review will be undertaken of the different models for the control of insolvency proceedings and the model adopted in China.

Models of control in formal proceedings

Insolvency schemes around the world tend to adopt complex governance structures involving a blend of controls by insolvency practitioners; the courts; the debtor, under supervision; and creditors. Historically some systems have adopted one dominant form of governance. It was possible to categorise[7] systems as entailing either the retention of control by the debtor, subject to structured supervision by the courts or an insolvency practitioner; or a system where creditors, in particular secured creditors, drive the process;[8] or a process of restructuring under supervision by an insolvency practitioner. However increasingly there has been convergence towards a more balanced governance arrangement.

China has opted to follow a model with a central managerial role for insolvency practitioners but where the courts are involved in every major process. They not only deal with conflicts regarding substantive rights, but they resolve procedural issues as well. In a nutshell, the situation in China is that the system has ostensibly moved from being tightly controlled by the government to a system where the courts play the major governance role, with an insolvency practitioner occupying a managerial role, unless the company's directors apply to retain managerial control, and there is an additional role for creditors.

Roles of administrator

One of the new features of the governance framework under China's new bankruptcy law is the establishment of the legal institution of administrator, which in most cases replaces the outdated liquidation group, which was normally constituted by officials from different government departments. A weakness of the liquidation group was that those officials who were provisionally organised to act in the group normally did not have expertise in accounting and insolvency laws. That meant that they had to employ qualified accountants and lawyers to deal with technical issues and provide legal advice to the liquidation group. There is no doubt that this process caused extra expense and delay.[9] In addition, since these officials were nominated by government, administrative intervention was unavoidable.[10]

Pursuant to the new bankruptcy law, the administrator will be nominated when the application for reorganisation is accepted by the court. As discussed further below the court monopolises the power to appoint an administrator.[11] In some jurisdictions like the UK and Germany, only an individual natural person can serve as an administrator,[12] but in China, the administrator may be either an intermediary agency, which embraces law firms, accounting firms or bankruptcy & liquidation firms, or a natural person who is professionally qualified to act.[13] In practice the great majority of administrators who have been appointed to the roster are law firms and accountancy firms, with only a small

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7 C. Tabb and A. Curtis Campbell, 'The Importance of Bankruptcy Law to Economic Development and Implications for China' (2006) 22 Insolvency Law and Practice 98. These historical divisions are however becoming increasingly blurred and many systems offer a combination of these approaches.

8 Historically the case in the UK, although this control is now diluted.

9 Y. Xu, *The Speech on Enterprise Bankruptcy Law* (Law Press-China, Beijing, 2006), pp.181-182.(in Chinese)

10 H. Zhang, 'A Notable Feature of China's New Bankruptcy Law: Administrator' (2009) 6 *International Corporate Rescue* 98.

11 Bankruptcy Law 2006, articles 13 and 22. Key details of the appointment processes are set out in 'Regulations of the Supreme People's Court on the Appointment of Administrators for Hearings on Cases of Enterprise Bankruptcy'. See T. Wang, 'Regulations of the Supreme People's Court on the Appointment of Administrators for Hearings in Cases of Enterprise Bankruptcy' (2009) 42 *Chinese Law and Government* 85 and 98.

12 In the UK, the insolvency practitioners, as individual professionals, can be appointed to act as administrator. In Germany, the trustee must be an individual rather than a legal entity. In addition, this trustee must be suitable to the case and independent from the debtor and all the creditors. See German Insolvency Code (InsO), section 56 (1); C. Paulus, 'The New German Insolvency Code' (1998) 33*Texas International Law Journal* 146.

13 Bankruptcy Law 2006, article 24; M. Simmons and J. Jiang, 'A New Insolvency Law in China' (2007) 4 International Corporate Rescue 10, 11. It is submitted that the law retains the institution of the liquidation group to act as an administrator merely in the circumstances where SOEs are put into bankruptcy proceedings.

number of authorised individual administrators.[14] It is important to note that the new law remains unclear as to whether or not an international insolvency professional who is quite familiar with China's bankruptcy legal framework can be designated as an administrator.[15] It is submitted that, since the law fails to exclude this situation specifically, this possibility at least exists. Especially at present, in view of the insufficiency of insolvency experts who have been professionally licensed in China, the participation of skilled and experienced foreign professionals can enable China's judiciary to fill a huge skills gap.

Once the court accepts a petition for reorganisation proceedings it will designate an administrator, who is required to take over the assets and the business affairs of the enterprise. The administrator must discharge his duty loyally and diligently, otherwise he may be punished with a fine upon the court's order. If the interests of the debtor, its creditors, or a third party are damaged, owing to a breach of this general duty, a personal liability to compensate will be imposed.[16]

The Administrator is entitled to dissolve or accept the contracts entered by the debtor prior to the acceptance of the case yet which not yet been fully performed by both parties and to notify its counterparty. Where the Administrator fails to notify the counterparty within 2 months after the application for bankruptcy is accepted or fails to respond within 30 days from the date of being pressed for a response by its counterparty, the contract shall be deemed to be dissolved. Where the administrator decides to continue to perform the contract, the counterparty should perform as required and the counterparty is entitled to demand the administrator to provide a guarantee. Where the administrator fails to provide a guarantee, the contract is deemed to be dissolved.[17] A bankruptcy administrator shall, in addition, perform the following functions and duties:

(1) taking over the assets and seals as well as the account books and documents of the debtor;

(2) investigating the financial status of the debtor and drafting financial statements;

(3) deciding the internal management of the debtor;

(4) deciding the overheads and other necessary expenditures of the debtor;

(5) determining, before the initial creditors' meeting is held, whether to continue or to suspend the debtor's business;

(6) managing and disposing of the debtors' assets;

(7) participating in litigation, arbitration or any other legal procedures on behalf of the debtor;

(8) proposing to hold creditors' meetings; and

(9) any other functions and duties deemed appropriate by the Court.[18]

A bankruptcy administrator may, upon the approval of the Court, employ such relevant work staff as are considered necessary.

The administrator has the obligation to report to the creditors' committee if the administrator performs functions involving a transfer or disposal of property and property-related rights. If there is no creditors' committee, the administrator shall report to the court.[19] In addition, the administrator shall submit a reorganisation proposal to the creditors' meeting and court within six months of the application for reorganisation being accepted by the court, and this period can be further extended by three months under a court order if a justifiable ground is demonstrated.[20] This period is evidently much longer than the prescribed time in respect of the CVAs and administration procedures under UK legislation. It should be noted that if the administrator fails to produce a reorganisation proposal in the prescribed period, the court can terminate the reorganisation procedure and declare the bankruptcy of the debtor, and accordingly the debtor will be automatically put into liquidation proceedings.[21]

The remuneration of a bankruptcy administrator is decided by the Court.[22] Disagreement of the creditors' meeting in respect of court-decided remuneration could be raised before the Court.

Notes

14 A. Tang and P. Au, (2007), 'China's Enterprise Bankruptcy Law: the Central Government's New Regulations on Bankruptcy Administrators' available at <www.hkicpa.org.hk/APLUS/0711/p48_50.pdf>, last accessed 29 June 2010.

15 M. Falke, 'China's New Law on Enterprise Bankruptcy: A Story with a Happy End' (2007) 16 *International Insolvency Review* 63, 70.

16 Bankruptcy Law 2006, article 130. For a full understanding of the specific duties of an administrator, see article 25; M. Simmons and J. Jiang, 'A New Insolvency Law in China' (2007) 4 *International Corporate Rescue* 10, 12.

17 Bankruptcy Law 2006, article 18.

18 Bankruptcy Law 2006, article 25.

19 Bankruptcy Law 2006, article 61.

20 Bankruptcy Law 2006, article 79 (1) (2).

21 Bankruptcy Law 2006, article 79 (3).

22 See the 'Regulations of the Supreme People's Court on the Determination of Remuneration for Administrators in the Hearing of Enterprise Bankruptcy Cases'.

Secured creditors

Secured creditors, normally banks and financial institutions, enjoy priority in the scheme of asset distribution. They are entitled to dispose of the collateral and to obtain recovery from the proceeds of the sale of collateral which does not belong to bankruptcy estate. It should be noted that the secured creditors are not free to exercise their enforcing right at any time in liquidation proceedings. When a bankruptcy case is accepted and the debtor has been declared insolvent, the debtor's assets will be subject to an automatic stay and so the secured creditors are not allowed to dispose of the collateral. The law however enables the secured creditors to enforce their right against collateral after the court adjudicates the insolvency of debtor.[23] In the reorganisation procedure, there is an automatic stay on the debtor's property during the reorganisation period which runs from the time when the reorganisation application is accepted by the court until the reorganisation proposal is finally approved by the meetings of creditors and sanctioned by the court. However, in the case of possible damage or significant depreciation of value of the collateral, which may impair the interests of the secured creditors, the secured creditors may petition to the Court to be exempted from the stay.[24]

Under the old bankruptcy legal framework, especially in the 'policy-oriented bankruptcy' (also called 'planned bankruptcy') structure for SOEs, the state banks, usually as secured creditors, made concessions to labour claims in the distribution of the insolvent estate, primarily because of the inadequate social security system.[25] The government had been more concerned with labour-related implications of an insolvent SOE and normally the proceeds from the sales of collateral were used to realise the labour claims prior to the recovery by secured creditors under government policies, rather than bankruptcy legislations.[26] In relation to a financially troubled SOE, the most valuable asset is normally the land and in China the land is owned by the state.[27] An enterprise can obtain the rights of use of land by two ways: administrative allocation and conveyance of land. An enterprise could acquire rights of use of land by making payment of the land conveyance fees in auction and signing a contract with relevant government authorities.

Ordinary unsecured creditors

The ordinary unsecured creditors, such as trade suppliers and consumers, who are ranked at the bottom of the queue, normally get little or nothing from distribution. The new bankruptcy law has addressed the weak position of ordinary unsecured creditors in some respects, especially in the reorganisation process where the class of ordinary unsecured creditors is organised to negotiate and vote upon the reorganisation proposal.[28] Rejection by the class of ordinary unsecured creditors could impede the approval of the rescue proposal.[29] Thus, such substantive and procedural rights ensure better treatment of these weak interested parties, and further avoid the reorganisation procedure being at the mercy of major creditors. However, there are no redistribution provisions like the British abolition of the preferential status of Crown debts[30] and top-slicing 'prescribed part'[31] funds for unsecured creditors which could immediately and effectively enhance the debt recovery of the weak creditors. It is submitted that the weak position of ordinary unsecured creditors has not been fundamentally changed yet.

Employees

It is noteworthy that in China every enterprise, particularly each state-owned enterprise, has a labour union. A certain number of representatives of the labour union are appointed to be directors or supervisors who are able to be involved in the decision-making process, or the supervision of the management in the corporate governance structure, which enables the workers to exert their influence on the big commercial activities through their representatives in the two boards.[32] This arrangement reflects a unique Chinese characteristic that the workers have strong powers in the SOEs.

Notes

23 Bankruptcy Law 2006, article 109.
24 Bankruptcy Law 2006, article 75.
25 R. Parry and H. Zhang 'China's Corporate Rescue Laws: Perspectives and Principles', (2008) 8 *Journal of Corporate Law Studies* 113, 117.
26 H. Zhang 'Bankruptcy of State-owned Enterprises and Planned Bankruptcy', in R. Rebecca, Y. Xu and H. Zhang (eds), *China's New Enterprise Bankruptcy Law: Context, Interpretation and Application* (Ashgate Publishing, Farnham, 2010), p.300.
27 PRC Land Administration Law, article 8.
28 Bankruptcy Law 2006, article 82.
29 However, the objection of class of unsecured creditors is subject to the cramdown rules. See Bankruptcy Law 2006, article 87.
30 Enterprise Act 2002, s 251.
31 Insolvency Act 1986, s 176A; The Insolvency Act 1986 (Prescribed Part) Order 2003, SI 2003/2097.
32 For more details regarding the Chinese corporate governance structure, see L. Miles and Z. Zhang, 'Improving corporate governance in state-owned corporations in China: which way forward?' (2006) 6 JCLS 213.

Moreover, the new bankruptcy law also stipulates that there should be one representative of the labour union on the creditors' committee which is authorised to perform a series of important functions in the bankruptcy and corporate rescue proceedings.[33] In the insolvency proceedings, the employees with unpaid wages and social security claims are preferential creditors who are ranked right behind the bankruptcy expenses and debts for the common interest in the distributional order. In the reorganisation procedure, the employees will be organised in voting classes to discuss and approve the reorganisation procedure. The objections of the voting class of employees may cause the failure of reorganisation.

In contrast to other jurisdictions, it can be observed that the protection to the employees in troubled firms is still not sufficient, primarily on account of the social infrastructure. For example, in England, the affected employees enjoy preferential status in the distribution of bankruptcy estate. They are also entitled to claims against the National Insurance Fund if their unpaid wages and social security are not fully recovered. In addition, the affected employees are also under the protection of the Transfer of Undertakings (Protection of Employment) 'TUPE' Regulations 2006 which do not allow the unfair dismissal of employees when a transfer of business from an insolvent firm occurs.[34] In China, prior to the economic transition from a planned economy to a market economy, every SOE was a self-sufficient 'welfare society' which offered medical care, life-long employment and housing. In addition, the SOEs also provided basic facilities, like hospitals, canteens and school and nursery facilities, which imposed heavy financial burden on the enterprises. When SOEs were put into insolvency proceedings, there was a troublesome issue about whether the facilities like hospitals and schools, which were financed under the subsidy of the SOEs, should be categorised as part of the bankruptcy estate. Although these facilities belonged to the debtor enterprise, they were closely related to the daily lives of the workers. In cases where a SOE was wound up and its bankruptcy estate was transferred to another company, the laid off workers would not enjoy benefits. The law was silent as to this sensitive issue which was usually resolved by administrative measures.[35] If the labour-related issues could not be resolved in a good way and in a timely manner, there was significant potential for social unrest to break out. Accordingly the Chinese government has been very sensitive to the labour claims of an insolvent SOE and has always played a significant role in the rearrangement of affected workers.

Creditors' meeting

The creditors' meeting has significant powers even though it is not a standing body in bankruptcy proceedings. Once the court accepts a bankruptcy application, the court shall make a public notice for the creditors to file their claims within a specified period. Only the creditors who file their claims within the prescribed period are able to join the creditors' meeting and exercise powers of voting and supervision.[36]

Before the new bankruptcy law was established, some legal reformers contended that the creditors' meeting should have the power to remove an incompetent administrator which was appointed by the court once a bankruptcy application was filed. Other reformers argued that the court should have the final say as to the removal of an administrator. This debate lasted for a long time and in the end, the legislature adopted the latter position. As a compromise, the creditors' meeting is entitled to apply to the court for the replacement of the incompetent administrator and it is the court that makes the decision.[37]

The initial creditors' meeting shall be convened by the court within 15 days following the expiration of the prescribed period for the filing of creditors' claims, and it shall perform the following functions and duties:

(1) checking claims;

(2) requesting that the court replace the bankruptcy administrator and to check the expense and remuneration of the bankruptcy administrator;

(3) supervising the bankruptcy administrator;

(4) selecting and replacing members of the creditors' committee;

(5) deciding whether to continue or close the debtor's business;

(6) adopting reorganisation plans;

(7) adopting composition agreements;

(8) adopting a management plan in respect of the debtor's assets;

(9) adopting the scheme of appraisal of the bankruptcy estate;

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33 Bankruptcy Law 2006, articles 67 and 68.
34 Directive 2001/23/EC, Art 4 (1); TUPE 2006, Reg. 7 (1)(2).
35 F. Chen, 'Chinese Bankruptcy Law: Milestones and Challenges' (2000) 31 *St. Mary's Law Journal* 49, 58-59.
36 Bankruptcy Law 2006, article 59.
37 Bankruptcy Law 2006, article 22.

(10) adopting a distribution plan in respect of the bankruptcy estate;

(11) any other functions and duties as are deemed appropriate by the Court.[38]

A resolution of the creditors' meeting requires the support of a majority in number and half in value of the total amount of claims. If the management plan in respect of the debtor's assets and the scheme of appraisal of the bankruptcy estate are not approved by the creditors' meeting, they could be ruled upon by the court. If the distribution plan is not approved by the initial creditors' meeting and not resolved by the second creditors' meeting either, this plan could be ruled upon by the court.[39] In other words, in relation to the above three kinds of plans, the court has cramdown powers on similar terms to those of United States judges.[40]

Creditors' committee

The creditors' committee is not a compulsory organisation and may not be required in all bankruptcy cases. The establishment of a creditors' committee may be appropriate where there are a large number of creditors whose claims are dispersed, and the creditors' committee can effectively perform their functions as representatives of the creditors.[41] The creditors' meeting is entitled to decide whether to establish a creditors' committee. The creditors' committee is constituted of the representatives of creditors who are selected by the creditors' meeting, and a representative of the labour union or workers' congress of the debtor. The selection of the members of the creditors' committee needs the written confirmation of court.[42]

The creditors' committee plays a significant function of supervising the bankruptcy administrator. In order that significant transactions are brought to the attention of the committee the administrator is required to report the following matters to the creditors' committee without undue delay: (1) a transfer of ownership of real estate such as land or houses; (2) a transfer of property rights such as mining exploration rights, mining rights or intellectual property rights; (3) a transfer of all inventory or business; (4) any loans; (5) a provision of security; (6) an assignment of claims or transfer of securities; (7) the performance of any contract that has not been fully performed by the debtor and its counterparty; (8) a waiving of rights; (9) a withdrawal of collateral; (10) any other disposition of property having a material effect on the interests of creditors. Where there is no such creditors' committee, the specified activities shall be reported to the Court without undue delay.[43]

Existing management of insolvent firms

When a bankruptcy application is filed by the court, an administrator will be appointed to displace the existing management staff and take control over the assets and business affairs of the debtor. The relevant personnel of the debtor will bear the following obligations: (1) to appropriately keep the property, seals, accounting books, documents, data, and other articles under their possession and management; (2) to work as required by the court and the Administrator and to respond to inquiries in strict accordance with the facts; (3) to attend the creditor's meeting as a non-voting delegate and answer their inquiries in a faithful manner; (4) not to leave the place of domicile without the permission of the court; and (5) not to assume any post of director, supervisor, superior officer of other enterprise.[44]

A range of civil and criminal penalties may be applied to directors and other managers. Where debtor violates the provisions thereof by refusing to submit, or submitting fraudulent, statements as to its financial status, a detailed list of debts and claims, financial and accounting reports, payment of employees' wages and social insurance premiums, the court may impose a fine upon the offending personnel. Where debtor refuses to hand over the materials such as property, seals, accounting books, documents to the administrator, or where managers fabricate or destroy relevant evidence about the property to the extent of obscuring the property status, the court may impose a fine upon the offending personnel.[45] A director, supervisor or senior manager who violated the duties of loyalty and diligence, and caused the bankruptcy of the debtor, shall assume civil liability. In addition, they are prohibited from acting as a director, supervisor or senior manager of any other company within three years following the termination of bankruptcy proceedings of the debtor.[46] If the

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38 Bankruptcy Law 2006, article 61.
39 Bankruptcy Law 2006, article 65.
40 Bankruptcy Law 2006, article 87; US Code, Title 11, §1129(b).
41 United Nations Commission on International Trade Law (UNCITRAL), *Legislative Guide on Insolvency Law*, (2004), p.197.
42 Bankruptcy Law 2006, article 67.
43 Bankruptcy Law 2006, article 69.
44 Bankruptcy Law 2006, article 15.
45 Bankruptcy Law 2006, article 127.
46 Bankruptcy Law 2006, article 125.

directors and senior management staff conceal the debtor's property, assume fabricated debts, transfer and dispose of property by other means, and cause serious loss to the interests of creditors or interested parties, they may face imprisonment for no more than 5 years, and/or a fine of RMB 20,000-200,000.[47]

These civil and penal provisions may be regarded as operating as 'sticks' to deter the directors and managers from doing illegal and irresponsible things, particularly when the company is in financial difficulty, otherwise they will assume civil liability, disqualification or even criminal offence. In contrast the reorganisation procedure in China's new bankruptcy law may be regarded as providing a 'carrot' to the directors and managers of a financially troubled company who are entitled to apply for the proceedings to be debtor-in-possession (DIP) proceedings. If the application is sanctioned by the court, the directors and managers will not lose control of the company. This could encourage the senior management staff to initiate corporate rescue proceedings in a timely manner.

Position of courts

The court plays the central role in the governance of the Chinese insolvency proceedings at all stages of the process. This central role may potentially add to the time and expense of proceedings, although the courts are able to mediate among different interest groups and can potentially perform the role of a balanced, objective and independent adjudicator. A wide range of functions are performed by the courts under the new bankruptcy law.

The court acts as a rule maker. Before the new bankruptcy law was enacted, the Supreme People's Court (SPC) produced two significant judicial interpretations respectively in 1991 and 2002 in order to facilitate the application of the outdated 1986 law. It should be noted that the new bankruptcy law confers on the judiciary significant powers to make relevant regulations. According to Article 3 (3), the SPC is empowered to make separate regulations as to the appointment and remuneration of administrator. On 4 April 2007, the SPC issued the 'Regulations of the Supreme People's Court on the Appointment of Administrators for Hearings on Cases of Enterprise Bankruptcy' and 'Regulations of the Supreme People's Court on the Determination of Remuneration for Administrators in the Hearing of Enterprise Bankruptcy Cases', both of which became effective on the same date as the new bankruptcy law. Most importantly, the SPC has organised an insolvency law review committee since July 2007 to consider any ineffectiveness or ambiguity of the new law. A regulation in the form of a judicial interpretation will be released by the SPC in the near future to resolve the problems which have been encountered in practice.

As noted previously, the court also acts as a gatekeeper to the intermediary agencies and insolvency professionals, since the courts at provincial level set the conditions of qualification for organisations and individual persons wishing to qualify as administrators. Interested law firms, accountancy firms, bankruptcy & liquidation firms, and individual professionals, such as lawyers and certified public accountants (CPA), are entitled to provide application materials to the local provincial high courts. The high courts shall organise a review committee to deal with these materials and license the competent applicants.[48] The members of the committee are normally the judges in local courts, so it is very difficult to be sure of fairness and justice. The successful applicants will be listed in a local roster under which bankruptcy cases will be allocated by the courts. Obviously, the access to undertaking the business of insolvency-related cases in China is under the complete control of the judiciary.

The court has a further gate-keeping role, since the access to bankruptcy proceedings is controlled by the court, which will investigate the evidence and documents that are submitted by the applicant for winding up, reorganisation or reconciliation, and will then determine whether or not to accept the application.[49] If the bankruptcy or reorganisation application materials do not satisfy the insolvency conditions stipulated in Article 2 of the new law, the court is entitled to reject the application. If the reconciliation application is not in accordance with the requirements set out in Article 95 of the new law, the court can reject the reconciliation application.[50] If the court accepts the case, it is required to nominate an administrator and determine his fees, to release public notice to inform creditors and to specify a period in which the creditors should file their claims against the debtor.[51]

The court acts as an organiser. It should notify any known creditors, and issue public notice for the filing of creditors' claims.[52] In addition, it is required to convene

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47 Criminal Law Amendment Six 2006, article 6.
48 Regulations of the Supreme People's Court on the Appointment of Administrators for Hearings on Cases of Enterprise Bankruptcy 2007 (hereinafter 'Regulations of Appointment 2007'), article 10.
49 Bankruptcy Law 2006, article 7.
50 Bankruptcy Law 2006, article 96.
51 Bankruptcy Law 2006, articles 13, 14, 22 and 45.
52 Bankruptcy Law 2006, article 14.

the initial creditors' meeting. For instance, in the liquidation proceedings, the court shall convene the initial creditors' meeting within fifteen days after the period for the filing of claims expires.[53] In the reorganisation regime, the court is required to call the meetings of creditors in different voting groups within thirty days after the court receives the reorganisation proposal submitted by the administrator or the debtor in DIP.[54] In the reconciliation procedure, once the court accepts the reconciliation application, the court shall issue a public notice and summon the creditors' meeting to discuss the reconciliation proposal.[55] If the creditors' meeting decides to set up a creditors' committee, the members of the committee need the written confirmation of the court.[56]

The Chinese modified reorganisation procedure draws upon some notable features of the US Chapter 11, DIP model.[57] Once the court accepts an application for reorganisation, the court shall appoint an administrator who will take over the assets and management affairs of the debtor. This is the practitioner-in-possession (PIP) model, similar to the UK Administration procedure.[58] However in the reorganisation procedure, the debtor could apply to the court for conversion of the proceedings to DIP.[59] The court will assess whether the existing management team of the debtor are able to deal with the risks and reorganisation-related matters. In addition, the court will take into account the opinions of employees, creditors and interested parties. DIP proceedings cannot be commenced without court sanction.[60] Once the court allows the DIP application, the administrator which was initially appointed by the court shall hand over the assets and business affairs back to the debtor, and the administrator automatically will become a supervisor who is entitled to monitor the debtor's behaviour.[61]

Potential influence of government

The state is entitled to participate in the bankruptcy or reorganisation proceedings in its capacity as a creditor, since it will normally be owed a substantial amount of unpaid taxes by a troubled firm. In addition, the troubled firm may have used up the social security deductions which will have been collected by the firm itself on behalf of the state and which it is supposed to pay the relevant government agencies on time. If the claims of the state cannot be fully recovered, the loss to the state will fall ultimately on the tax payers and public service cuts. It can be observed that the state enjoys a strong position in bankruptcy and corporate rescue regimes even though the debts owed to it by the struggling firm are normally not secured with assets. The state is potentially able to exploit other resources to enforce its claim and obtain advantages in the insolvency proceedings on the basis of the state's superior authority and powers of coercion. It has strong incentives to realise the back taxes and social security deductions on the basis of its strong power of enforcement and advantageous position in the ranking of distribution. The powerful status of the state as a player in the bankruptcy or corporate rescue legal framework may have a significant impact on the interests of the other interested parties. The more that the state grabs from the pool of the bankrupt estate, the less there is left for the other creditors; moreover, the state's immediate and strong enforcement of the repayment could lead to the reduction of the remaining assets which will surely destroy the probability of rehabilitation of the ailing firm and ruin the rescue culture.[62] To some extent, the attitudes, incentives and efforts of the state may determine the difference between success and failure of a rescue attempt.

A unique strength of state is that it could design bankruptcy rules which confer priority upon government agencies, and subsequently seize assets in priority to other creditors. It is therefore observed that the state is not only a rule-maker but a significant player as well in bankruptcy law.[63] Under China's new bankruptcy law, the claims of the state, including for unpaid tax and social insurance deductions, rank behind secured debts, the expenses of liquidation and labour claims, but ahead of ordinary unsecured creditors.[64] Apart from the roles of a law-maker and an interested party in the bankruptcy legal framework, the state could also

Notes

53 Bankruptcy Law 2006, article 62 (1).
54 Bankruptcy Law 2006, article 84 (1).
55 Bankruptcy Law 2006, article 96 (1).
56 Bankruptcy Law 2006, articles 62 and 67.
57 D. Hahn, 'Concentrated Ownership and Control of Corporate Reorganizations' (2004) 4 JCLS 117.
58 V. Finch, 'Control and co-ordination in corporate rescue' (2005) 25 *Legal Studies* 374.
59 Bankruptcy Law 2006, article 73.
60 W. Wang, *The Interpretation and Substance of Bankruptcy Law* (Law Press-China, Beijing, 2007), p.215.(in Chinese)
61 Bankruptcy Law 2006, article 73.
62 B. Carruthers and T. Halliday, *Rescuing Business: The Making of Corporate bankruptcy Law in England and the United States* (Clarendon Press, Oxford, 1998), p. 212.
63 *Ibid.*
64 Bankruptcy Law, article 113.

play a role of providing finance to troubled firms. In the previous centralised planned economy and at the beginning of the economic reform, the Chinese central government used to set aside a large amount of funds from the annual budget to assist distressed state-owned enterprises and rearrange the employment of laid-off workers, but now this situation is changing very fast along with the establishment of the emerging socialist market economy and entry into the WTO. Only 10% of state-owned enterprises' total funding is derived from the state budget.[65] This trend is in line with the principles of competition laws which strongly restrict the government from stepping in, in order to maintain fair competition among economic entities in the free market.[66] Although the situation that the state tended to bail out distressed state-owned enterprises has changed so far, the state may still be likely to provide financial aids to salvage some ailing SOEs, in particular the large and influential enterprises, the life or death of which will have a significant impact on the stability of the local region.[67] Last but not least, the state can act as a coordinator in reorganisation cases regarding SOEs. When the rescue process or negotiation falls into difficulty or deadlock, the local government and relevant agencies may assist in providing solutions to the disagreements, offering special policies to the troubled firms and mitigating the dissatisfaction and concerns of the affected employees. The administrator and court will to some extent rely on the local government in relation to labour-related issues, because at present a developed social security system has not been established in China. In the near future, the state involvement in the bankruptcy and corporate rescue cases of SOEs is therefore likely.

Conclusion

The effective operation of China's new bankruptcy law depends on the skills and expertise of insolvency practitioners who are playing significant roles in dealing with insolvency-related issues under the supervision of the creditors' meeting and the court. The court decides the appointment, removal and remuneration of bankruptcy administrators and is involved in every major step of a corporate insolvency or rescue case. Another notable aspect of China's insolvency law practice is state intervention which could effectively resolve labour claims and disputes among tax, social insurance deductions and loans of state banks. This is why the state involvement remains even though it may bring about many negative factors. The Supreme People's Court has organised a special committee to review the operation of the new law and to produce a judicial interpretation in the near future since the new law came into force. The balance of power and control among the judiciary, state, insolvency professionals and different interested groups might be slightly changed.

Notes

65 F. Allen, J. Qian and M. Qian, 'Law, finance and economic growth in China' (2005) 77 *Journal of Financial Economics* 80.

66 For the relevant provisions of state aid in the EU, see Articles 87-92 EC Treaty; Leigh Hancher, Tom Ottervanger, and Piet Jan Slot, *EC State Aids* (Sweet & Maxwell, London, 2006).

67 R. Parry and H. Zhang 'China's Corporate Rescue Laws: Perspectives and Principles' (2008) 8 *Journal of Corporate Law Studies* 113, 140.

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